

1-22-1985

Hearing on Telephone Divestiture - One Year After: Impact on State Consumers and Providers

Senate Committee on Energy and Public Utilities

Follow this and additional works at: http://digitalcommons.law.ggu.edu/caldocs_senate



Part of the [Consumer Protection Law Commons](#), and the [Legislation Commons](#)

Recommended Citation

Senate Committee on Energy and Public Utilities, "Hearing on Telephone Divestiture - One Year After: Impact on State Consumers and Providers" (1985). *California Senate*. Paper 42.

http://digitalcommons.law.ggu.edu/caldocs_senate/42

This Hearing is brought to you for free and open access by the California Documents at GGU Law Digital Commons. It has been accepted for inclusion in California Senate by an authorized administrator of GGU Law Digital Commons. For more information, please contact jfischer@ggu.edu.

CALIFORNIA LEGISLATURE
SENATE COMMITTEE ON
ENERGY AND PUBLIC UTILITIES

HEARING ON
**THE TELEPHONE DIVESTITURE --
ONE YEAR AFTER: IMPACT ON STATE
CONSUMERS AND PROVIDERS**



TUESDAY, JANUARY 22, 1985
ROOM 112, STATE CAPITOL
SACRAMENTO, CALIFORNIA

KFC
22
L500
E54
1985
no. 2

KFC
22
L500
E54
1985
no.2

CALIFORNIA LEGISLATURE
SENATE COMMITTEE ON
ENERGY AND PUBLIC UTILITIES

LAW LIBRARY

GOLDEN GATE UNIVERSITY
HEARING ON

**THE TELEPHONE DIVESTITURE --
ONE YEAR AFTER: IMPACT ON STATE
CONSUMERS AND PROVIDERS**



TUESDAY, JANUARY 22, 1985
ROOM 112, STATE CAPITOL
SACRAMENTO, CALIFORNIA

85-6-405

INDEX OF SPEAKERS

Senator Herschel Rosenthal, Chairman

Sylvia Siegel, Executive Director
Toward Utility Rate Normalization

Ken McEldowney, Director
Consumer Action

Marie Shibuya-Snell, Director
Department of Consumer Affairs

Reed Waters, Vice President
Regulatory Relations, Pacific Bell

Bill Woods, Vice President
External Affairs
American Telephone and Telegraph Company

Herman Bluestein, Director
Regulatory and Public Policy Law
MCI

Robert A. Ringman, Executive Vice President
California Independent Telephone Association

Donald Vial, President
Public Utilities Commission

Carl Lawson, Assistant to Chief
Common Carrier Bureau
Federal Communications Commission

A few remarks were made by Mr. Albrecht
of the Department of Consumer Affairs

Closing remarks by Senator Herschel Rosenthal

Adjournment

California Legislature

NEWTON R. RUSSELL
VICE CHAIRMAN

ALFRED E. ALQUIST
RUBEN S. AYALA
RALPH C. DILLS
JOHN GARAMENDI
GARY HART
JOSEPH B. MONTOYA
JIM NIELSEN

SENATE COMMITTEE ON ENERGY AND PUBLIC UTILITIES

HERSCHEL ROSENTHAL
CHAIRMAN

ANN GRESSANI
PRINCIPAL CONSULTANT

PAUL FADELLI
ASSOCIATE CONSULTANT

PATRICIA STEARNS
COMMITTEE SECRETARY

ROOM 2035, STATE CAPITOL
SACRAMENTO, CALIFORNIA 95814
TELEPHONE: 445-9764



AGENDA

Tuesday, January 22, 1985

1:30 P.M., Room 112, State Capitol

SUBJECT: -- The Telephone Divestiture -- One Year After:
Impact on State Consumers and Providers.

CONSUMER PANEL

Marie Shibuya-Snell
Director
Department of
Consumer Affairs

Sylvia Siegel
Executive Director
Toward Utility Rate
Normalization

Ken McEldowney
Director
Consumer Action

UTILITIES PANEL

Bill Woods
Vice President
External Affairs
American Telephone & Telegraph Co.

Reed Waters
Vice President
Regulatory Relations
Pacific Bell

Herman Bluestein
Director
Regulatory & Public Policy Law
MCI

Robert A. Ringman
Executive Vice President
California Independent
Telephone Association

REGULATORS PANEL

Donald Vial
President
Public Utilities Commission
State of California

Carl Lawson
Assistant To Chief
Common Carrier Bureau
Federal Communications
Commission



CHAIRMAN HERSCHEL ROSENTHAL: I'd like to welcome everyone to the first hearing on the Committee on Energy and Public Utilities for this new session. I'm pleased to announce we have four new outstanding members on the committee and I'll introduce them as they arrive here today. Senator Morgan has already arrived and I'd like to introduce her to everyone in the room. I'm very pleased that she has agreed to join the committee. One of the older members is here who everyone knows...

SENATOR NEWTON RUSSELL: A retread.

CHAIRMAN ROSENTHAL: ...a retread, Senator Russell. I also wanted to indicate that in addition to the other guests who are going to be on the program, we have representatives of General Telephone and resellers who are in the audience, if the committee members have specific questions for them later. And it's my pleasure to introduce at this time, I know he can only stay for a short period of time, but I'd like to have Commissioner Duda...Commissioner, my pleasure to have you here. He has been appointed to the commission and will be coming up before too long for confirmation and I anticipate no problems in his confirmation.

We've organized an informational hearing today on the health of the telephone system in California in this year 1 A.D. - one year After Divestiture. It's proper that we begin the year by discussing the breakup of the nation's phone system because no issue that will come before this committee is more important than preserving an accessible and affordable communications system for everyone in California. Also, few issues are as confusing to the consumers, to the involved utilities, and to the regulators than our changing phone system.

We have brought together impressive representatives of these three groups because quite frankly, state legislators are also confused. Confused about the transition from Ma Bell to Pac Bell, confused about where the state's responsibility to protect ratepayers conflicts with other legislative and regulatory bodies, and confused about the telephone bills we receive in the mail. I hope that those of us who have been working closely on these issues in the past, as well as the new members of the committee, will be educated and sensitized to what has happened in the last year and what needs to happen in upcoming years to guarantee phone service that we can be proud of in California.

We have a busy agenda today so I'd like to get started. The hearing will be conducted in three panels. The first panel will be the consumers followed by the utilities, and lastly we'll hear from the regulators, President Don Vial of the PUC and a representative from the Federal Communications Commission. In order to guarantee enough question and answer time for the Senators and each panel, I want to ask that each witness keep his or her opening statement brief, not more than five to ten minutes. From each of you I'd like to hear where you were one year ago and how you are doing today, and

where we should be going in the future.

We'll start with the consumers' panel. We have three members. Sylvia Siegel, the Executive Director, Toward Utility Rate Normalization (TURN), Ken McEldowney, Director of Consumer Action, and Marie Shibuya-Snell, the Director of the Department of Consumer Affairs. Will the three of you please come up. Sylvia, why don't you start?

MS. SYLVIA SIEGEL: Thank you, Senator. Welcome, Senator Morgan. I'm happy to see a woman on this committee. Hello, Senator Russell and Senator Alquist, I hope you will pay...

SENATOR ALFRED ALQUIST: (inaudible statement)

MS. SIEGEL: Do you think that was discriminatory, Senator? I think women are especially sensitized to these bread and butter issues that every household faces. I know you are too, Senator, and I expect the best out of you this session.

(laughter)

One year ago we were worrying about where divestiture would lead because there appeared to be no sensible orderly plan and direction for the breakup of the largest company providing a necessitous service to both residential and business services. We were particularly concerned at that time with almost \$4 billion of rate requests before the Public Utilities Commission in the State of California, which included...hello, Senator Mello...a \$1.2 billion rate request to cover general operating expenses and profit rate, \$1.8 billion to cover interstate access charges, even for those people who made no long distance calls whatsoever, and \$1.2 billion for those customers who made intrastate long distance charges. After 105 hearing days in the quasijudicial process where these applications are scrutinized by the staff and all of the parties, the recommendation went into the commission and much to our chagrin, the first bite of the apple that went into effect January 1985, amounted to \$445 million more than they should have received. The commission properly put the \$1.2 billion intrastate access costs on the long distance California calls where they should be. The \$1.8 billion interstate access requests was before the Federal Communications Commission and because of nationwide pressure on access charges, and of course being an election year, I suppose that had something to do with it, that issue in part was disposed of but the majority was deferred until after the election, and currently we face \$1.00 residential access for interstate, plus 35¢ a month to support those big business customers, whoever they may be, who possibly may bypass the system. The interstate charges for most of the business users have been put into effect.

Where are we now? Currently, Pac Bell is before the commission with over \$2 billion in further requests. Let me explain those and what our problem is. One is a shift of \$232 million for a 15 per cent increase on every basic monthly charge for centrex business and residential customers. Simply on the allegation that these long distance carriers who now bear that charge, mind you that's Sprint, MCI, et cetera, who are

supposed to pay some costs to hook into the local network, but apparently they and Pac Bell have agreed to shift it to the local customers. That's the first bite of that apple. Downstream we've already been warned that there's \$600 million more in shift coming. Okay, \$232 million is currently before the commission and we think not one penny of it ought to be reissued.

\$517 million was filed to cover a so-called attrition or cost of living allowance, something that should be banned now in the face of really very minimal inflation, lower cost of money, different economic circumstances and so on, that were adopted. Again, that would be a significant increase to the customers.

Thirdly, they wanted \$13.8 million to recover a penalty the PUC properly imposed on the company last June for not utilizing all of the equipment they have installed. As you know, everytime they install a piece of plant or equipment they earn a profit on it so it's to their advantage to do it whether they use it or not. The regulatory principle is that the equipment has to be used and useful and the commission did a stunning study to show that \$95 million should be imposed as a penalty. The commission in June adopted a \$45 million penalty. Now Pac Bell wants to recover a third of that saying they are utilizing two thirds of the equipment that were found not to have been utilized before.

Separately, as you know, the company is coming in for \$1.4 billion in a general rate increase which will go to trial in a month or so, to become effective January 1986. Now why are they doing all of this? I think there are several key principles involved on the company's side that are anti-consumer. Number one, they want to shift all of the operating costs to the local captive customer. Number two, they want to make a venture capitalist out of the local customer. They expect the local voice grade customer to pay for all of the modernization of equipment though it's very questionable that all of the fibre optics, for example, which include heavy investments, are necessary to serve local voice grade customers. We have asked for a study of voice grade local service standing alone without all of this other stuff. We anticipate that will come in in the next rate case.

Thirdly, they want to reprice all telephone services. I'm sure the telephone company folks will tell you they are already redefining the dictionary. The plain old flat rate service they are now calling "premium flat rate". Pretty soon they want to make that flat rate just a dial tone and charge you \$8.25 or whatever it is their new request will amount to. So they want to charge you for the dial tone and thereafter by every minute of time, every mile of distance, they want to make a long distance call out of every local call. That's an important principle that consumers across the country are united against. It's wrong. It's wrong. It's wrong. You have to help us to beat it back.

Thirdly, what they are trying to do, what the PUC staff, or at least what some members of the staff are doing, unhappily are entering in or wanting to enter in - we're going to prevent it - enter into a sweetheart agreement with members of the FCC and Pac

Bell to represcribe the service lives of all of their equipment. That's a fancy term. All it means is to shorten the service lives, collect more money from the customers. That, and the modernization principle, are intimately intertwined. I should note for you that of the \$1.4 billion in the new general rate case going to trial in January, about a third of that involves this faster depreciation and downstream it'll be about \$1 billion within the next three years. So when I'm very caustic about the sweetheart arrangement I hope we can prevent it between FCC, PUC, and Pac Bell. I point out that \$1 billion in represcription costs are involved.

Now I can only give you conclusionary statements here. I'm sure you're going to ask a lot of questions which I'll be glad to answer. I don't want to go beyond the instructions of the chair.

CHAIRMAN ROSENTHAL: Thank you very much, Ms. Siegel. First of all I'd like to introduce another outstanding new member of the committee, Senator Greene. Senator Mello is a retread. Very happy to have you here. All right, Senator Russell.

SENATOR NEWTON RUSSELL: Ms. Siegel, a couple of questions. Your 15 per cent increase on local phone users that you referred to earlier as being borne by them and it should be borne by the long distance purveyors - does that issue, regardless of whether you agree with it or not, does that issue relate to the bypass issue, or is it said by some to relate to the bypass issue?

MS. SIEGEL: Those are the allegations, Senator Russell, but during the trial that was held we went into this issue with great thoroughness and none of the allegations or none of the study held up. I can bring to you all of the transcripts of that trial to show you in our brief, and I'll be glad to submit that to you how that didn't really hold up. There's always been bypass. There's some bypass now, there may be some in the future. It is a boogie man.

SENATOR RUSSELL: Well, let me ask you a simple question which I think you can answer in simple terms that I can understand. Is it basically true that to the extent that, for whatever reason, the long distance phone users, or purveyors, are saddled with increased costs that makes bypass somewhere down the line more and more attractive until they cross over that line and will go into bypass thereby having a negative effect upon the costs being borne by the local users? Is there truth in that?

MS. SIEGEL: Not really. In theory there may be. In practice it's not so and the very large user, even the Bank of America which would be the first expected to bypass, has said that it will not.

SENATOR RUSSELL: It will not because of a sense of public service or on a dollar and cents hard business decision where some other company may not have that public service image, would it not be true?

MS. SIEGEL: If I were a businessperson, and I know Bank of America is a hot businessperson, they only consider the dollars and I'm sure they're doing it on the basis

of economics.

SENATOR RUSSELL: Has any other large user said they would not bypass?

MS. SIEGEL: As far as I know that's the testimony in the case.

SENATOR RUSSELL: Would you support a law to preclude bypass?

MS. SIEGEL: I don't know how you can.

SENATOR RUSSELL: I don't know that you can either and I'm not advocating it. I'm seeking information. I have one more question. The modernization, the shorter depreciation time - from your knowledge are there tax benefits from doing that?

MS. SIEGEL: They may be but they certainly don't offset the \$2 billion construction budget that the telephone company spends every year. Incidentally, that \$2 billion annual expenditure is entirely internally generated. That is spectacular for any utility company. Instead the stockholders' money is being spent by Pacific Telesos to go to Spain, China, Britain, anywhere else where they can diversify and make lots of bucks for their stockholders, which is fine except they are imposing on the ratepayer stockholder functions of capital formation. That's not fine.

SENATOR RUSSELL: But in the tremendous rapidity with which technological advances are being made today, making everybody's head swim, wouldn't they fall farther and farther behind if they didn't keep turning over their stock to modernize and update and be competitive?

MS. SIEGEL: No, sir.

SENATOR RUSSELL: Well, usually when you find a better way to do something, while there's initial costs, the ultimate costs to the consumer oftentimes go down.

MS. SIEGEL: Senator, as you know, the telephone industry is a high tech industry and even over the course of the last ten years when other high tech industries, namely the computer industry, has found it's unit costs going down and it's priced in the marketplace, the telephone costs have gone up. And our telephone bills are going to reach \$70 a month for local telephone service.

SENATOR RUSSELL: But that's not fair to make that analogy because...

MS. SIEGEL: You bet it's fair, that's the high tech industry.

SENATOR RUSSELL: ...let me finish. But how much of that increase, that 70 per cent increase, or \$70 increase that you refer to, how much is that related to the fact that the whole system of using the phones are different now? The cream is being skimmed off by the long distance user. Are those same costs related to the long distance user? Those costs are going down. Same technology being used.

MS. SIEGEL: Let me answer that in this way and make several points. One, the long distance user is using the universal base of the local operating companies. They should pay for that privilege, the long distance users. I don't think we should excuse them from our fair share of the costs of the total system. What is basic to this consideration, Senator, is that data transmission requires a higher quality of

transmission than voice grade. It may require the fibre optics. On the other hand, the company is saying everybody needs fibre optics, which is not true, and the captive regulated customers are going to pay for the fibre optics and the expensive \$50 million switches, et cetera. So you have to analyze all of these costs and allocate whom they benefit. Primarily, they are going to benefit the large data transmission market and I don't know about you, but I sure don't feel like paying for that. If I have a computer in my home I'd be willing to pay that share, but I think it's deplorable that low income people who are going to be forced off the system entirely will be deprived of telephone service because of these huge costs that are being forced down our throats and we're not going to take it.

SENATOR RUSSELL: Mr. Chairman, I'll conclude with this observation. It's hard for me to understand where one system of the telephone company costs are going up, skyrocketing with technology, but the other system, the long distance company business, the costs are going down. There's technology involved in both and it's rather difficult to understand how those two fit together.

MS. SIEGEL: I'll be glad to detail that in a letter to you, Senator Russell.

CHAIRMAN ROSENTHAL: Let me ask a question, Ms. Siegel. For a long time you've denied what some economists believe to be a given - that the long distance profits subsidize local calls - that if the profits no longer subsidize local calls, that the local service must cost more. Why do you believe this to be false?

MS. SIEGEL: Why is that false? Is that your question? Senator, over the years as you know, I've been in this field since 1969, and over the years I've been in touch with all of the reliable telecommunications' economists, engineers, and so forth, across the country, many of whom who have appeared as our witnesses. They know the cost of every wire, every nut and bolt that goes into an operating system. It is their expert testimony that the business, the myth of the long distance customer subsidizing the local customer is exactly that, a myth. It is proved now by studies of local telephone service operation in several other jurisdictions, including the State of Kansas, the State of South Carolina, and some others, and we hope that a proper study in the State of California will show the same facts. That is, that the cost to operate a strictly local telephone service stand alone company is a lot less than the company is saying.

CHAIRMAN ROSENTHAL: Then obviously you don't agree with the concept which says that according to their figures it costs "x" numbers of dollars and cents to provide service to each home and that the consumer has not been paying the costs? Obviously, the companies have been making money.

MS. SIEGEL: Generously.

CHAIRMAN ROSENTHAL: Well...

MS. SIEGEL: Look at the Wall Street Journal for October the 17th where both General Telephone's and Pacific Telephone's third quarter statements were the highest ever

attributable to the rate increases. Look at the year-end statements. You'll see that General Telephone's California company is doing exceedingly well. So I take all of those statements and I take all of the studies put in by the telephone companies with a grain of salt, Senator, and that's why we're there, to analyze and take them apart and reconstruct a proper factual basis.

CHAIRMAN ROSENTHAL: But if in fact the telephone company is making a larger percentage of profit than what's been indicated, maybe the PUC will take care of that.

MS. SIEGEL: Oh, I don't rely on that.

CHAIRMAN ROSENTHAL: The PUC is supposed to guarantee a certain rate of return and if in fact those figures are higher than what they've been basing their rate of return in terms of what's passed on to the ratepayer, you might see a different approach at the PUC. You don't think that will happen?

MS. SIEGEL: I know that's not so. The PUC just ruled on SoCal Edison and SoCal Gas where the staff recommended a rate of unequity of something like 15.5, and they found another \$10 or \$12 million in each company that could be chopped off, but the commission, in their questionable wisdom, turned around and gave them a 16 per cent rate on equity even though Edison Company had been earning in excess of their authorized return for some months. So we never can rely on the commission. I have good friends on the commission, but I tell you that.

CHAIRMAN ROSENTHAL: Thank you very much. Any other Senators?

SENATOR RUSSELL: I just wondered if Ms. Siegel could provide the committee with the statements of the economists which she alluded to which support her comments that long distance rates have not been subsidizing the local phone?

MS. SIEGEL: I'll be happy to.

CHAIRMAN ROSENTHAL: Because we know, for example, that long distance rates are coming down as other companies are providing the service. I have not heard of any of these other companies wanting to pick up on the homeowners' telephone business. They've only been interested in the long distance business.

MS. SIEGEL: Because that's where the heavy traffic is. Senator, the...

CHAIRMAN ROSENTHAL: Obviously, that must also be where the profit is.

MS. SIEGEL: That may also be where the profit is and they are creaming the skim, skimming the cream, as you said, and they're creaming the skim too, and they're not paying their way, so there are several cautions there.

CHAIRMAN ROSENTHAL: Nationally our PUC has the reputation of being stingy with utility rate requests compared to other such bodies throughout the country.

MS. SIEGEL: Not really. When they allow 17.5 per cent return on equity in 1981 as they did, that was the highest rate in the country at the time, and 16 per cent now is one of the highest rates in the country currently.

CHAIRMAN ROSENTHAL: Do you see any positive results for consumers coming out of

divestiture?

MS. SIEGEL: That's a tough question to answer.

CHAIRMAN ROSENTHAL: Because everything you've said has been negative in terms of...

MS. SIEGEL: Of course. I see a positive result coming out for the big operators and the big business customers. They will get lowered rates. All of those costs will be pushed on the little captive local customer.

CHAIRMAN ROSENTHAL: With that we'll move to the next person on the agenda, Mr. McEldowney.

MR. KEN McELDOWNEY: Thank you very much and thank you very much for having this hearing today because I think that the issues being discussed are very important and I think together with the banking problems, I think telephone and banking are the two key consumer issues on the mind of consumers today.

I sense a fear or insecurity within the Bell System that is pulling local operating companies and AT&T away from their historic commitment to universal service. The change appears to be the result of the imposition of deregulation. Deregulation now appears to have become internalized with potentially very serious adverse affects on those customers who, either because of location or income, will be unable to pay what is thought to be the cost of providing telephone service. Since this change in attitude among top executives is the result of what appears to be a national commitment to deregulation, it is this larger context I wish to look at first.

As examples of the impact of deregulation I am first going to look at what has happened in transportation and banking and then swing back to telephones. In all three areas there are common threads. Firms now have the authority or permission to add or drop services based on profit expectations, not on historic considerations of whether or not a service was needed. In some instances the changes are firmly in place. In others, some restrictions still exist. The other common thread is that deregulation has been associated with some serious problems. For many of us the problems of deregulation in airline travel has been largely hidden. Hidden because the adverse impact has not hit the large cities. Here deregulation has been largely positive. One doesn't have to look at ads in too many copies of the San Francisco Chronicle, the Chicago Tribune, Washington Post, or New York Times to be convinced that deregulation is the wish fairy for the air traveler. Coast to coast travel is now as low, if not lower, than it ever has been before. In recent ads I learned that I could fly from San Francisco to New York for \$119, Washington for \$125, and Atlanta for \$129.

From major city to major city, especially coast to coast, airline deregulation has been a blessing for the most part, but try explaining about deregulation of the airline industry to a friend in a small city off the beaten path and you might get a reaction that you didn't expect. The theory of deregulation as applied to air travel is that if you free up entry and exit from routes that a balance will be struck between supply and

demand. In other words, let new companies form and compete with the oldtimers. Let firms enter and leave markets and over a period of time a balance will be struck that will result in lower fares and more choices. The theory has an answer, even for those smaller cities that have been abandoned by the major airlines, but if there really is a need, smaller commuter airlines will start up or else a regional company will find it worthwhile to expand to serve your area.

In theory it does sound attractive but in practice the actual experience of many cities has been much more bleak. That is, what has been true is that the major airlines have cut back on the number of smaller cities they serve. Before deregulation a major airline could and had to, because of fare regulation, they were able to offset, offset losses and the less popular routes had slightly higher fares than the more profitable ones. The commuter and regional airlines can't do that. Virtually all their routes must turn a profit or else they will go out of business. Over the last few years smaller airlines serving smaller communities have gone belly up, so to speak, leaving cities with either greatly reduced service or no service at all.

I'm on a consumer advisory panel with a judge who lives in Fresno, California. He has found it more convenient and quicker to drive to meetings in San Francisco and Los Angeles rather than to rely on flights in and out of Fresno. A woman who is active in consumer affairs in California lives in Modesto. She was served by United prior to deregulation. Now United is gone, as are a number of small airlines that came, flew for a while and went out of business. Limited service is now provided with 19-seat planes.

A more serious problem faces even smaller cities with the deregulation of intercity bus companies. Here too, Greyhound and Trailways have had far greater freedom to drop routes in whole cities if not a profit is being made. The impact on small communities has been quite severe.

We've also discovered similar trends taking place in banking, but here is not so much geography that limits a person's options as it is the amount of money or income a person might have. Deregulation has been a way of life for banks and savings and loans the last four years. During that time service fees on bank and savings accounts have doubled. Every indication points to even greater increases in the future.

Deregulation of the telephone industry is much newer. Only one year has passed since the magic number of 1/1/84, which now seems to just roll off the lips. As a result, the impact is not as obvious or as widespread, but the tendencies are there and even more frightening to me is the change in attitude among telephone executives which may even compound the problem. With companies that were formerly part of the Bell System, it is almost as if a collective sort of brainwashing has taken place. As I walk down the hallways of various telephone headquarters I almost expect to hear quiet chants of "deregulation is good, regulation is bad, deregulation is good, regulation is bad." When regulation is discussed you usually hear "level playing field" blurted out repeatedly.

It is as if some mysterious religious group seized the leaders of the telephone industry and in a very short period of time convinced them that all aspects of regulation that brought us universal service is now to be rejected out of hand, and instead we must look solely to the profit motive and cost-based pricing to allocate resources and determine who receives telephone service and at what price.

The driving force behind this change appears to be the boogie man of bypass. I don't think anyone will deny that bypass is a potential threat. What is open to question is how serious the threat is and how rapidly it will take place. But even more important in my mind is how the phone companies react to this perceived threat. The gut response, whether in Washington or before state PUC's and PFC's, is that the access charges must be shifted from the long distance carriers to customers, both small business and residential customers, if bypass is to be slain. Early figures indicated in California that such a shift of intrastate and interstate access charges would cost individual residential customers \$8 to \$10 a month. In other states the bite would be even greater.

Again, I don't want to focus on whether bypass is a threat or even whether such a shift would prevent large corporations from leaving the system. Instead I want to come back to what I call the change in attitude. During the fight in Congress in 1983 and 1984, I never heard a phone company executive talk about what type of impact such a hike would have on individual customers. The closest was a submission of studies that indicated only a small percentage of customers would leave the network, but nothing was said about what sort of cutbacks families with low and fixed incomes would have to make in food or clothing in order to find the extra \$10 each month needed to keep their phone service as a vital lifeline to the outside. And what of cost-based pricing, a new guiding force that has come into the telephone industry? What impact will it have on low income customers as the price for local telephone service nudges towards the \$29 that Pacific Bell claims it costs each month to maintain a single phone. Even more of concern is what impact it will have on the rural customer where the monthly cost, according to Pacific Bell, may be three times as high as the cost of providing service in an urban area? And what of other cost-based questions such as starting service? Can we really expect a low income customer to pay the full actual cost of installing a phone? What of the poor person who moves into a rental unit without modular jacks or highly inadequate inside wiring? Can we expect that person to pay the full cost of conversion or laying of the inside wires?

I'm not that familiar with other states, but here in California the PUC seems so concerned with insuring that monthly rates will be affordable that in some ways it's concern has contributed to problems in other areas. The California PUC-approved rate for phone installation and coined phone toll calls are even higher than Pacific Bell asked for. This is all well and good for people who already have phones, but very unfair for those who don't. I fear we're moving toward a situation with phones that's already too

clear in the transportation industry and becoming clearer all the time in banking. Increasingly service will be provided at a rate that is designed to cover the cost they've allocated to that service. This will be necessary because it is claimed that the so-called subsidy that is currently present in the system in terms of long distance access charges in intraLATA toll charges will slowly disappear. It will disappear partially because it's demise seems to be a foregone conclusion, at least with the telephone executives.

What is the answer? I'm not sure. I'm not even sure that I care about the answer at this point. What I am concerned about is the attitude within the phone industry that seems to say that nothing can be done. But some possible solutions have been advanced, primarily by consumer groups - a tax on bypass, tax on telephone equipment, making bypass illegal, tax on long distance calls. Consumer groups continue to fight for possible solutions to the problem. Phone companies either join with us and stand firmly within the tradition of universal service or else drag their feet claiming that nothing can be done and squander the goodwill they have built up over the decades. The choice is their's.

I wanted to just mention in conclusion a couple of points that were brought up in the earlier interchange between Sylvia and the committee. One of the real issues, and I don't think that when you talk to consumer groups whenever you talk about a subsidy that's being provided by long distance calls, blood pressure and temperature will rise to a certain degree. But all we're talking about is the allocation of costs and what we have and what seems to be the intent of the telephone company, to a certain extent the PUC and the FCC, is to have all the fixed costs be allocated on the end user. In other words, all the fixed costs of providing the local loop, the wires and the poles, that cost should be borne by the local customers, both residential and small business customers. And the long distance carriers would only be responsible for the variable costs. This is why you have a situation in which long distance charges can come down and potentially will come down in the future, because the long distance companies and the long distance callers are not being asked to bear their fair share of the fixed costs.

One added point is it seems very inconsistent to me for the phone company on the one hand to be pushing very strongly local measured service, because what they say is they want people to pay their fair share in proportion to the number of calls they make, and at the same time say that an accelerated depreciation should be used to insure more widespread application of fibre optics. One of the real features of fibre optics, in addition to the quality of the transmission, is that one thin thread provides virtually unlimited capacity. But it's beyond me to understand why at the same time consumers should be asked to pay for the accelerated depreciation and the installation of fibre optics which provide unlimited capacity, virtually unlimited capacity, and at the same time be told that they should be forced to pay basically long distance rates for local

calls based on time and distance because there are capacity problems with the system. Thank you.

CHAIRMAN ROSENTHAL: Senator Russell.

SENATOR RUSSELL: I wasn't quite sure of your final two sentences. Would you go through that again please? You're saying...

MR. McELDOWNEY: What I just said now? Okay. What's very interesting to me is that there seems to be a very inconsistent position taken by the phone company. On the one hand they're talking about that people aren't paying their fair share. In other words, they're talking about people who make large numbers of calls in a given day, putting strains on the system, and that because of that they should be forced to pay per minute, per mile. At the same time what they're saying is there should be widespread installation of fibre optics which basically is opposed to copper wire where there is real capacity problems, have virtually no capacity problems. If anything, the installation there is a greater cost in terms of local measured service for the phone company in that billing is much more complicated and you have to have additional equipment to be able to monitor those calls. So if anything...

SENATOR RUSSELL: With fibre optics?

MR. McELDOWNEY: No, No, I'm talking about with a local measured service because of the switches and the billing and keeping track of both the distance and the time of calls. It seems to me that they can't have both. They can't both expect consumers to pay through accelerated depreciation for fibre optics and at the same time say that there are capacity problems, and for that reason there needs to be local measured service.

SENATOR RUSSELL: But your switching and all of that business, does fibre optics do away with a need for a lot of that type of equipment?

MR. McELDOWNEY: Well, I'd have to yield - basically with fibre optics - what happens is the equipment that is necessary to make fibre optics work is relatively expensive to be able to maximize the use of that capacity.

SENATOR RUSSELL: It seems to me that there's just so many phone calls that can be made on an existing cable and if you use fibre optics, then the future expansion is already there.

MR. McELDOWNEY: Right. In that case there should be unlimited callings for a fixed price. Why should there be any measuring of service if, in fact, there is unlimited capacity?

SENATOR RUSSELL: Well, it costs, I guess, to put the fibre optics in. I guess they've got to get the money back from that some way.

MS. SIEGEL: Senator, the peak use that the telephone company has to be able to serve, the peak use of the day, is between ten and twelve in the morning, which is the busy period made by business calls. Primarily all this fibre optics business and all of the switches and so on, are really being installed to serve the large business data

transmission customer. The incremental cost to serve residential customers is zero. There may be new development where you have to add wires and so on, but the actual central office capability is generally installed to serve the big business customer. That's what the whole business is about.

SENATOR RUSSELL: Let me ask you this and then I'm through, Mr. Chairman. You take a business, say, in the City of Los Angeles. Let's assume hypothetically that they don't do any business outside the County of Los Angeles. Are they considered then a local telephone user or a long distance telephone user?

MS. SIEGEL: It depends. They just split up the zones into zone usage measurement so whereas they had a 40 or 50 mile calling distance before in Los Angeles, San Diego, and Sacramento, now a local call is only 8 miles, and you should see the letters of complaint we get on that. I'm sure you do.

SENATOR RUSSELL: Is everything beyond 8 miles then considered long distance?

MS. SIEGEL: Well, it's considered a zone, a zoom call, and they charge extra for rate bans.

SENATOR RUSSELL: Doesn't this hypothetical business then pay those same charges, the same as I would on a personal call?

MS. SIEGEL: Yes, they do. Right.

SENATOR RUSSELL: Well, you're saying that all this was put in for the purpose of the business, this particular business, but if it's all within the same area, they use it just the same as I would.

MS. SIEGEL: Except the business customer has to use it to hook his computer to the modum, to the telephone, and that takes a different quality of transmission. That does take fibre optics and they're doing a lot of data transmission and they want the local small business and residential customer to pick up the cost of all of that installation. The local customer doesn't need it. You know the question is, how much high tech do we need really? That's a hard answer to give.

CHAIRMAN ROSENTHAL: I'd like to move it right along. The Director of the Department of Consumer Affairs, Marie Shibuya-Snell. I hope I pronounced that correctly.

MS. MARIE SHIBUYA-SNELL: You did, Senator. Senator Rosenthal and members of the committee, I'm really pleased to be with you here this afternoon to discuss the status of the AT&T breakup and to consider the state's options and responsibilities at this time. Here with me, as well, are Tom Cecil who is the Chief of Consumer Services and Deputy Director of Legislation, and Richard Elbrecht, Supervising Attorney for the Legal Services Unit, the real experts in this area.

In preparing for this hearing I asked my staff for information about the breakup of the telephone system. One of the more enlightening documents is a summary of the viewpoints expressed by consumer groups at the time the proposed divestiture was just controversial, appear to be sound. These groups, the Consumer Federation of America, the

Consumers' Union, the National Consumer Law Center, and the State of Nevada's advocate for Consumers' of Public Utilities, were in basic agreement that the proposed divestiture should go forward. All of the consumer groups expressed concern, however, about the effect of the proposed divestiture on rates of regular phone service and the possible impact on universal service. Yet there appears to have been a near consensus in support of the proposed divestiture.

Today, however, the basic decision to break up the Bell System has become quite controversial and many are blaming AT&T, the U.S. Justice Department, or Judge Greene of increasing phone costs. I, too, share a deep concern about the increasing cost of regular telephone service and especially it's impact on the poor, on elderly citizens and others with fixed income. However, our new lifeline service mandated by the More Universal Service Act has moderated the impact of the rate increases on families with annual incomes of \$11,000 and less. In areas served by Pacific Bell that enjoy local measured service, for instance, monthly rates for basic service, including 30 unlimited calls per month, will be \$2.23 monthly, less a 75¢ allowance for a telephone, for a net of only \$1.48 per month. For only flat rate services available, the lifeline rate is \$4.13 per month, less the 75¢ credit for a net of \$3.38 per month. The Moore Act's lifeline program is financed by 4 per cent sales tax on toll calls occurring within California. For those whose incomes are at or below the poverty level, that program will help.

As a result, in part of that work by our department, the procedure for signing up is really quite simple. People need only to call their local telephone company business office and request service. It is only necessary to sign a simple certification form. We have also worked with Pacific Bell in designing a leaflet and a series of media announcements that will publicize the availability of the new lifeline service and tell low income consumers how to sign up. Our department has also worked with AT&T to provide discounts and special benefits to Californian's 60 years of age and over. Beginning in May of 1984, during Older Americans' Month, AT&T became a participant in the Department of Consumer Affairs' Golden State Senior Discount Program, which encourages businesses to provide discounts to seniors and provides technical assistance to them in that effort. AT&T will offer a 10 per cent discount on selected products and it will also sponsor information outreach programs via local senior citizen centers.

We also sponsored a series of conferences throughout the state that provided a forum to enable consumers, consumer advocates, business representatives and members of the news media to share their insights and information. The conference consisted of three panel discussions. First, equipment leases, purchases and repairs. Second, long distance services, and third, billing inquiries and complaints. Panelists included representatives from Pacific Bell, AT&T, GTE, MCI, Sprint, PUC, and consumer organizations. Questions from the audience were honored and information kits were made

available to those who attended.

We have also written and published materials designed to upgrade the advertising of telephone equipment and implement the 1983 legislation requiring certain disclosures. This legislation, AB 1425, known as the Moore bill, requires telephone equipment retailers to disclose the phone's dialing methods, whether it's tone or pulse, as well as who is responsible for the equipment repairs. Our leaflets have been distributed nationwide and are also being sent to advertisers who fail to comply with the new law. The department's educational efforts have also included several articles in our periodical, Consumer Affairs, and a fact sheet on what consumers should look for when buying a telephone. One of our staff attorneys is also serving as a member of Pacific Bell's consumer advisory panel, which helps insure that consumer interests are taken into account by the company in the course of developing and implementing it's policies and plans.

We have also responded to complaints from individual consumers regarding telephone equipment and telephone service. The volume of complaints, however, has not been substantial. Our Complaint Assistance Unit received only a total of 77 complaints during the second half of 1984. Of these, 48 involved equipment problems and 29 involved service problems. The only significant concentration of complaints was in the area of equipment repairs which accounted for 18 of the 48 equipment problems.

While the cost of telephone service has assuredly been increasing, I'm convinced that a telephone call is still one of our best buys. When compared to the cost of a trip by car, even over a short distance, the cost of a telephone call is really next to nothing. Shopping by phone is something we've all done and I predict that we will do more and more of it, and banking as well. If a telephone is an alternative to the fiscal transportation of people, products and information, which it often is, it's true worth to the consumer is even more self-evident. We're in the midst of a revolution in telecommunications that will affect all of us in ways that none of us can predict. In the long run I have faith that this will bring both better and relatively less expensive telecommunication services to the consumers, businesses and government.

From the vantage of both the Legislature and the Department of Consumer Affairs, it would seem that our primary job would be to maintain a watchful eye on both the marketplace and the PUC, always being prepared to address problems as they arise, anticipate critical issues, and respond accordingly. With these various forces at work I'm optimistic about the future of the telephone service for the consumers of California. Thank you very much for this opportunity to appear here today and I also have brought with me some folders which I would like to distribute to you for your information.

CHAIRMAN ROSENTHAL: I have a couple of questions. You've indicated that there weren't very many calls. It's interesting. I've heard that legislators have more calls than you have. Now maybe that's because nobody knows how to get in touch with you. How

do you respond to that?

MS. SHIBUYA-SNELL: Well, I'm sure that certainly we're not saying that those are all the calls or all the complaints. I'm just indicating the numbers of calls that the Department has received. That certainly is not to minimize...

CHAIRMAN ROSENTHAL: I'm referring to - I think that if the telephone users knew that the Department of Consumer Affairs had staff that was ready and available to answer questions, I think you'd get a lot of phone calls. They know my phone number so they call me. What do you think...

MS. SHIBUYA-SNELL: We do, in general complaints, we do get about 1,000 calls per month throughout the year.

CHAIRMAN ROSENTHAL: But I'm talking about in terms of telephones, in terms of people not understanding their bills, in terms of the extra charges...

MS. SHIBUYA-SNELL: I'm sure that the phone company is receiving many of those, sir.

CHAIRMAN ROSENTHAL: What is the Department's relation to the PUC in responding to questions about telephone service?

MS. SHIBUYA-SNELL: How do you mean, sir?

CHAIRMAN ROSENTHAL: Is there any ongoing relationship between your Department and the PUC?

MS. SHIBUYA-SNELL: We always have communications whenever there are questions or problems.

CHAIRMAN ROSENTHAL: Well, I guess the PUC when they're here - whether they've had to respond to some of the concerns that were raised by you - I guess one of the things that is concerning me is what is the role, and I know that you've had some conferences around the state trying to explain what was happening and I, as a matter of fact, attended one of them - people generally, first of all, don't know where to complain, and second of all, once they complain and nothing happens as a result of that complaint, they begin soon not to complain anymore to you, perhaps. But I sensed kind of a revolution taking place out there among the average telephone user.

MS. SHIBUYA-SNELL: They are certainly becoming better informed consumers in this area.

CHAIRMAN ROSENTHAL: I don't understand what is happening to them and I've even said to the telephone companies, you haven't even explained what is happening to them. I, for example, see that the mailers have come and who is going to read all that verbiage? Using language nobody understands. What is a LATA and does the average telephone user know what a LATA is or...yes, I understand.

MR. McELDOWNEY: Probably some people would want to jump in on this too. I think the number of complaints that the Department has gotten is not at all indicative of the problem. I was on a local talk show in San Francisco last year and offered a publication, if you sent a self-addressed stamped envelope, on telephone tips, and we got

1,500 requests. We get multiple phone calls every day about problems with billing, problems with equipment, problems with warranties. There is incredible confusion out there, incredible frustration, and I think that the term you use in terms of revolution is not that far off the mark. And I'm sure that Sylvia has even more calls than we do.

MS. SIEGEL: That's true, Senator. We're also doing a mail solicitation program statewide and almost universally we're getting letters from users who are completely befuddled by what's happening out there, who are upset at charges, who simply have no explanation of what's going on and are very concerned. We get thousands of these letters.

MS. MARIE SHIBUYA-SNELL: Senator, by my indication of the number of complaints that the Department has received, by no means was my intent to minimize the problems. It seems to me that we have many experts out there in the field. The consumer groups have become experts. They have many more places to phone other than the Department and I'm glad to see that they're using the real experts. We're the generalists and Sylvia, and certainly Ken, are counted among the experts and recognized in the State of California as such.

MS. SIEGEL: We would welcome some of your general expertise in support of what we're doing as consumer groups and I'd be happy to sit down with you and work out a program as to how the Department of Consumer Affairs can assist consumer groups, particularly with funding to service all of these folks.

SENATOR ROSENTHAL: Thank you very much and that may have been one of the more important conclusions of this particular panel. May I ask now, please, for the Utilities Panel to join us. Bill Woods, Vice President for External Affairs, American Telephone & Telegraph Co., Reed Waters, Vice President, Regulatory Relations for Pacific Bell, Herman Bluestein, Director, Regulatory & Public Policy Law for MCI, and Robert Ringman, Executive Vice President, California Independent Telephone Association. Gentlemen, I want to reiterate, keep your statements short so we can spend some more time on the questions of the members of the panel, as well as some cross currents between you. So with that, Mr. Woods, would you begin.

MR. BILL WOODS: Thank you, Senator. I think it might be a little bit more helpful if we started with Mr. Waters, if he would agree, and then move forward.

CHAIRMAN ROSENTHAL: Oh, I have no problem with that. Mr. Waters.

MR. REED WATERS: Remember, I didn't volunteer to do this.

CHAIRMAN ROSENTHAL: Right.

MR. WATERS: First of all, thank you very much for the opportunity to talk about some of these problems. It's encouraging to us to know that we have a Legislature who is interested in all of these very complex issues. I'm not going to go back and try to reconstruct how divestiture came about. It happened for lots of reasons. There's only one thing, I think, that we can be sure of at this point in time, the industry has really

never...

CHAIRMAN ROSENTHAL: Excuse me, just one moment. Does anyone have any objections to a photographer taking pictures? Someone from Pacific Bell? Any members? No problem.

MR. WATERS: I was saying that despite divestiture one year ago, which is the basis for your hearing here today, the only thing that we're really sure of is that with this kind of momentous event that occurred the industry is never going to be the same. With that in mind I'd like to talk about things that we do know about what has happened in the past year. One, the major events, all of them that have taken place, and two, where we stand today in Pacific, and three, where we hope to be in the future.

Pacific has approximately 8.5 million customers in California, \$18 billion in assets, 75,000 employees, and more than 1.3 million shareowners. We serve 53 of California's 58 counties, and four out of every five citizens in California, and we are totally in support of universal telephone service, in spite of Mr. McEldowney's concerns.

I'd like to, just using some of those numbers, talk to Sylvia's point before I go on with my remarks, and her point was that no one has proven that basic rates don't subsidize toll in contrast to what the popular belief and general belief is that toll has in fact subsidized low basic rates. At divestiture, when we were separated from AT&T, AT&T took all of the interservice area LATA traffic from us and with that went 15 per cent of Pacific Telephone's assets, old Pacific Telephone, 15 per cent of the assets, approximately 40 per cent of all of the revenue went with those assets. In other words, the assets they took were generating 40 per cent of our total revenue. Now with that kind of a split I don't know how anyone could say that the long distance piece of this business, which AT&T took over, was not in large part contributing the bulk of what supported the entire system in California. We view divestiture in California as a tremendous opportunity for ourselves and our customers.

We also realize that from the day the consent decree was signed it was the object of a lot of opposition. The opponents argued that the decree gave AT&T the high growth, high tech part of the business, gave the local operating companies such as Pacific, the leftovers. Second, the opponents said the decree would force local rates to double and triple over predivestiture levels. Fortunately, neither scenario has occurred. In good measure I believe this has been due to the foresight of the California Public Utilities Commission.

Now let me discuss each of these in turn. First, the contention that Pacific has been left with the low growth, low tech part of the business. In fact, Pacific today is more high tech than ever before and leads the way in introducing new products and new services to its customers. Sylvia made quite a point up here of the fact that we are modernizing and why should residential customers pay for the modernization. I would just comment on that. I think it is terribly important to residential customers, because they're going to benefit by improved transmission, much lower maintenance costs, and much

greater reliability than we have today - all customers, residents, business, and otherwise. Another key point to the degree that we do have modern technology, our large users who are the heavy volume toll users who do pay the freight on the system today, are much more likely to stay with us rather than to build their own network with the kind of technology that they will need in order to survive in the information age. And this is important because our large users are, in fact, subsidizing all of the rest of the network's customers today.

So far the news about rates is also good. You may remember reports which said that after divestiture the cost of local service would quickly double. I'm here to assure you that no such thing has happened, nor do we expect to see it happen in the future.

CHAIRMAN ROSENTHAL: Mr. Waters, Senator Russell has a question.

SENATOR RUSSELL: On that point relating to Ms. Siegel's comments about the residential user doesn't really need or want the update and you're saying that by providing them the update, the benefit is to attract and to keep the large users for whom bypass is an alternative option, is that what you're saying?

MR. WATERS: Yes, that's a key thing and it's important to residential users that we do keep those business customers on our network. They're the ones who are really putting the revenue into the pot. One per cent of our business customers contribute 40 per cent of the business revenues in California. One per cent. Now it's awfully important if we're getting 40 per cent of all the revenues from the business segment that we serve, from one per cent of those customers, that we don't lose that one per cent. If we lose them, all of that revenue is in fact supporting the total system which is used by both residents and business customers in California. So it's awfully important to the residential customers that we maintain all of those business customers on our system. I'm saying the new technology will make it, even though we still have some economic problems with bypass, to the degree that we do have the kind of technology that they can now purchase themselves, that is an added incentive to stay with us. And secondly, if we start moving those prices toward not loading them with all of the costs of the local network, whether you go all the way, whether the interexchange carriers have to pay a portion of that or not is something that's going to have to be debated as we move downstream, but we need to send that kind of signal and that in its entirety is going to be the underpinnings of whether we're able to maintain universal telephone service in California.

SENATOR RUSSELL: I presume it would be impractical, perhaps impossible, to keep the present residential system as it is and add on top of that an additional system that would be used for the business people. That would not be economically viable?

MR. WATERS: Senator, no it isn't, it really isn't because we don't have separate wires running down the street for business customers, we don't have separate switches for the handling of traffic. The system is one giant computer and it is used by all of our

customers, residents and business alike. There are other advantages to modernizing this system to the resident customer beyond those which I've already talked about and they certainly relate to the fact that if our network is modern, thus is allowed, and that is a key point, to do all that it can do, it will give the capability of entering the information age to all of those resident customers at a much much lower price than would be the case if those who want to enter it are forced to buy their own equipment, to translate their own computer language from one to another, that can all be handled within that network. That's part of the capability that we're building.

In 1950 the basic flat rate telephone service in California, this is 1950, was \$4.75 a month. On the day that we were divested it was \$7.00. Today it is \$8.25. I certainly don't want to leave you with the impression that our current rates are not going to have to be increased. Today all resident customer basic telephone service rates receive a major subsidy in that the \$8.25 is still far below the national average and far below its costs, and even where basic rates are more than twice the level of those in California, and I'm talking flat rate residences, not lifeline at this point, where flat rate residence rates are more than twice the level in other states, the development and the numbers of customers served in those states is just as great as it is here in California. In other words, there has been no impact whatsoever on universal telephone service. Flat rate service at \$8.25 is so underpriced compared to its cost and its value that it is clearly not in the best interests of universal telephone service to continue to maintain the massive subsidy which flows to all of the residence customers. Most residence customers do not need that level of support and those who do are adequately cared for by the Moore Universal Service Act legislation as enacted last year by this Legislature.

Everyone is subsidized today and all do not need to be subsidized and that's the problem we have in moving our pricing structure to accommodate that kind of a look. If cost of flat rate service had just kept pace with the consumer price index, the charge would now be over \$20 a month, or about five times what it was in 1950. Instead, it hasn't even doubled in almost 35 years. I think it's especially important and especially important in achievement when we think of the value of being connected with the outside world 24 hours a day, 365 days a year. The only broad consumer service that has doubled since divestiture is the cost of a local coin telephone call. It's gone from 10¢ to 20¢ and the old rate of the coin call hadn't changed for more than 30 years.

Not too long ago phones were like Model T's. We had any color you wanted as long as it was black. Today phones come in every conceivable shape and size and with just about every feature anyone could hope for. Californian's are also free to choose from over 80 different long distance carriers in California. True, some customers are confused by all of these new products and choices that they have, but by the need to make a choice in an area where they once could not make one. I think people are learning how to do business in this new marketplace. We at Pacific Telephone are dedicated to attempting to act as

an integrator to explain to all of the customers that we deal with just exactly who they must deal with and how to contact them and holding them by the hand if we have to. I call that the integrator approach and that's why we're telling our customers to call us first. We know the kinds of problems that they are having and we believe that each of our 75,000 employees is in the business of trying to solve those problems. I think it's fair that despite many problems in the past year, we have improved the quality of telephone service and maintained reasonable prices.

We are encouraged that the California Public Utilities Commission has demonstrated a willingness to address all of these problems during the last year. Let me run through some of those things that they've done. Last year the Commission awarded us a \$565 million rate award. That really allowed us to continue to meet service needs in California, to remain financially viable as an independent entity, independent of the Bell System. Fully as important, I guess, is that rate relief was the Commission's order barring competition within our 10 service areas. Had the Commission ruled any other way, affordable telephone service today might be in jeopardy throughout the state because intraLATA long distance service provides nearly one third of the total subsidy to basic rates in California. That's the reason we're so concerned about that issue. It isn't that we're anticompetitive, per se.

Third, the Commission held hearings on the appropriate corporate structure for the new Pacific Telesis group. Two issues there were at stake - the possibility of cross subsidization from one company to another, and the imputation of revenues across company lines. We believe we've developed a framework which essentially deals with both of these issues. We've established a working relationship with the CPUC which gives them the full opportunity to track and audit all of the transactions between our regulated Pacific Bell entity, it's parent, Pacific Telesis, and each of the unregulated subsidiary companies of our parent company.

CHAIRMAN ROSENTHAL: Do you have a question, Senator Russell?

SENATOR RUSSELL: Yes, I just wondered where the other two thirds of that subsidy comes from?

MR. WATERS: Yellow Pages and other products, and we have a number of products that we do sell in Pacific Bell today that do make a significant contribution, not the least of which is the 976 announcement service. Directory advertising produces roughly \$330 million. In 1984 I think that was the net contribution. There are a number of other vertical services that are optional type services for customers. Call waiting, call forwarding, all of those custom calling features that are available to residence customers throughout the state all make a significant contribution. In other words, their revenues are substantially ahead of their costs.

The other piece of that comes in the interstate and interLATA intrastate traffic and it really comes from the access charges we are charging those carriers that do business,

such as AT&T and MCI in California. We're overcharging those carriers, I might say, overcharging as related to the cost of providing access to our local service.

(inaudible voice)

MR. WATERS: Well, all of those things go to make the subsidy but a big chunk of it is the access charge that we charge the carrier. Sylvia made a comment to the effect that we have asked the Public Utilities Commission in California to look at shifting a portion of those charges, which were very arbitrarily made, from the interLATA carriers back to the customers where the costs are really generated. That issue is before the Commission today. We want to do that to reduce the incentive for those carriers and their customers, because they have to recover the costs by charging prices to their customers, for bypass. It's just that simple. I don't believe there is an effective way of preventing bypass other than by an appropriate price structure.

SENATOR RUSSELL: Do you have any comments from Mr. Woods, or when he gives his testimony, to refute Ms. Siegel's assertion that the excess costs by long distance really never did go to subsidize the local user? Can you provide this committee with some factual information in that regard?

MR. WATERS: Well, I think I did when I said that when we lost the assets that produced - we lost 15 per cent of our assets which produced 40 per cent of our total revenues. Now 15 per cent of those assets that we transferred to AT&T on divestiture were producing 40 per cent of our total revenues. Those assets we transferred were not the local loops that Ms. Siegel is talking about at all. They were interLATA transmission switching facilities. Absolutely. Certainly the assets we transferred, the revenue that we lost which now has to be recovered either through carrier access charges or some other way, and can absolutely be verified.

CHAIRMAN ROSENTHAL: Let me just ask a question. For example, you can tell us how many actual dollars you lost as a result of this divestiture?

MR. WATERS: Revenue loss, yes.

CHAIRMAN ROSENTHAL: Okay, revenue loss. And then you could tell this committee how you are making up that number of dollars...

MR. WATERS: Yes.

CHAIRMAN ROSENTHAL: ...so that access charge would bring in "x" number of dollars, the various other services that you are selling would bring in "x" number of dollars, and those additional dollars would not exceed what you lost?

MR. WATERS: Well, to the degree that our costs have gone up, Senator, in the interim period and we did get a price increase from the California Commission, which I might add in spite of Ms. Siegel's comments that we're doing very well and therefore need no further rate increases, has still left us significantly below the authorized rate of return by this Commission - dramatically ahead of where we were two years ago we have made great improvement in our financial situation in California, Pacific Bell has, but

we're nowhere nearly up to the authorized level and I don't know whether there is any misconception. I was happy to hear Senator Rosenthal say we were guaranteed that rate of return. I've never looked upon it that way and I don't think Don Vial will exactly either. It's an opportunity to earn that much. Our costs continue to go up. Other issues which you sort of skirted upon, Senator Russell, earlier have to do with the way that the costs of our system are assigned since they're used for both interstate and intrastate traffic, and the ways that those are assigned either to the intrastate within California jurisdiction or to the interstate jurisdiction called separations, our assets, our expenses, and our revenues are divided up that way and a shift of that brought about outside of our control certainly, but in line with those methods that are prescribed by the Federal Communications Commission has brought about an increased intrastate revenue requirement, which if we don't recover it through intrastate services, services that are regulated by the California Public Utilities Commission, we're left with assets on which we can earn nothing, because we cannot earn on them on the interstate side. That's an issue.

CHAIRMAN ROSENTHAL: I guess there's something I don't understand. All of these other companies that are now competing for long distance, you took that total volume of business. Are you saying you lost more than that?

MR. WATERS: I don't have any idea what their total volume of business is because they don't publish that. I think AT&T does, but they are the only ones who are really regulated to the degree that they have to describe regularly their financial situation to the Public Utilities Commission. I'm saying that the amount of revenue we lost on divestiture which went away with the assets that generated that revenue, far exceed the proportionate amount that we shouldn't have lost if revenues were spread over all of the products and assets that generate revenue.

CHAIRMAN ROSENTHAL: Yes, but what you lost - and tell me where I'm wrong...

MR. WATERS: We're getting it back from them.

CHAIRMAN ROSENTHAL: ...what you lost is what you lost in terms of long distance revenue?

MR. WATERS: Right, which was ours before divestiture. It's now AT&T's revenue. To the degree that MCI and all of the other 80 carriers that I mentioned here have a piece of that. They've either gotten it through generating it because it's brand new usage, or they've stolen it from AT&T by some division of the market.

CHAIRMAN ROSENTHAL: Yes, Senator Mello.

SENATOR MELLO: Mr. Chairman, as you reflected how you held the line on your prices since 1950, what I'd like to know also is how many services you have deleted. I get a lot of complaints, for example, you are no longer providing a phone. That has to be sold or rented. You charge different types of installation fees, service calls - when something goes wrong, before you used to go out and fix it. Now with zone charges pay

phones have gone up double just recently, and directory assistance is now being charged for, I guess out of the area code or out of a zone. I don't think you're providing anywhere near as much service as you were back some years ago, yet you're holding a line perhaps but the consumer is paying a lot more now for these services that used to be thrown into the basic rate.

MR. WATERS: Yes, he probably is and the reason is that when we had a monopoly, when Pacific had the whole ball of wax, the whole nine yards, all of the long distance business, all of the terminal equipment business, and we could price all of those services at whatever level as long as we met the total revenue requirement of the business...

(10 minute gap on tape)

MR. WATERS: ...also in that Pacific Magazine we have listed in the centerfold of that all of the products and services we do now provide. Most of those shown in the centerfold are services that do provide a contribution. They're priced by the commission, they more than cover their costs. I appreciate the opportunity, again, to talk with you.

SENATOR MORGAN: Mr. Waters, we heard testimony earlier from Ms. Siegel about the possibility of a \$70 a month phone bill, phone rate. Do you foresee in this century this possibility and under what circumstances it would be possible?

MR. WATERS: I don't at all see that it would be possible or needed. I've used a word before and I'll use it again, that's poppycock.

SENATOR MORGAN: My second question is do you have a way of knowing at this point what percentage of your local customers are tied into computer hookups?

MR. WATERS: Are entitled to...

SENATOR MORGAN: Have computer hookups through your telephone system in their homes?

MR. WATERS: Are tied in today? Roughly, if I remember right, about 20 per cent of California residences today, this is much higher than any other state, have home computers today, and that's growing, but the highest of any place in the country.

SENATOR MORGAN: And they can be tied in with your phone system? What is the rate differential for those customers?

MR. WATERS: What is the rate?

SENATOR MORGAN: Do they pay the standard rate?

MR. WATERS: There is no change, they buy flat rate service or measured rate service, whatever they're subscribing to today and they use that service by typing their computer right through and tying it to a central data point and withdrawing data or interconnecting with them and that's particularly disadvantageous where the customer has flat rate service and he's a residence customer, he is in fact generating additional cost by the provision of switching equipment, which is a common type of equipment which all customers need to use and it is one of the reasons why for that kind of customer he

should be on a measured rate basis rather than flat rate.

SENATOR MORGAN: Are you trying to get that?

MR. WATERS: We certainly have and will continue to try to offer a measured rate service. It is our desire that the customer who wants flat rate unlimited calling should pay its full cost, and that over time, moving downstream, and we will always have a much lower entry measured rate option where the customer who wants to pay what his own usage would generate in the way of cost can. And we see that as a matter of providing a full choice to customers rather than attempting to get them all measured. We'll always have a flat rate option.

CHAIRMAN ROSENTHAL: Thank you very much, Mr. Waters. Mr. Woods.

MR. BILL WOODS: Senator and other Senators, I'm delighted to be here to offer some comments for your assistance and I'll try to shorten it in the interest of time. I think there are really three policy matters that should guide your committee in its consideration of the many issues regarding telecommunications. One is to support actions to maintain universal service, second is to support actions which will encourage the fullest and best use of the public switch network, both the local and interexchange network, and finally, support actions which will encourage marketbase pricing of long distance communications.

Clearly, as we have heard already, divestiture was an unprecedented event. It has had an adverse impact on many customers, but I'm happy to report that in terms of our customers in California, our consumers, they have been just as able to place a telephone call during one year before A.D. as they were before. And second, nationwide the same thing as occurred, so I'm pleased about that. Clearly, as Mr. Waters suggested, customers have had more choices. It has been a problem to move away from one-stop shopping and I wouldn't for a moment minimize that. On the other hand, customers have taken advantage of the choices and particularly in the long distance area.

We had a study done by Lou Harris and it would suggest that Californians, residence customers who spend \$50 a month or more, 22 per cent of them are using other carriers than AT&T, 38 per cent of business customers with 11 telephones or more are using carriers other than AT&T, and probably somewhere in the neighborhood of 60 per cent of large business customers spending \$300 or more a month use alternative carriers as well. And most of this, over half, both for residents and business, has occurred over the last year and I think that will increase as Pacific Bell goes forward with their easy access plan. Mr. Waters mentioned that there are more than 80 companies providing or planning to provide long distance service within the State of California and that's certainly true, but as you know, if you look at, as we've heard a lot about this business of pricing above cost, toward cost, et cetera.

I'd like to make just one point for Senator Russell. At about 1942, 1943, the long distance services in this country provided no support for local service, and it has

increased since then. Good reasons to move toward universal service, et cetera, but when it all started it was about the mid '40's and I'll be happy to provide you a book from the Congressional Budget Office which I think does an excellent job of summarizing that.

SENATOR RUSSELL: Do you have any statistics which shows the percentage of people in this country covered by telephone service at that time?

MR. WOODS: Oh, sure. I know what it was. It was 40 per cent.

SENATOR RUSSELL: Forty per cent of the people?

MR. WOODS: Forty per cent of the households.

SENATOR RUSSELL: And what percentage...

MR. WOODS: Ninety-five. And that was the whole purpose. The technology at that point in time and as its continued along, supported the idea of shifting costs from the local service to long distance and that was tied in with national policy and made very good sense and is, in fact, what occurred.

SENATOR RUSSELL: Was there any governmental edict or recommendation in that regard? Was this a result of meetings with business and government?

MR. WOODS: This occurred in what is called the federal joint board and the industry at that time - representatives of the Federal Communications Commission, representatives of the state commissions, working with the industry, came up with these procedures to shift costs.

SENATOR RUSSELL: And so that is a factual, evidential process?

MR. WOODS: Absolutely.

SENATOR RUSSELL: If somebody wanted to research it?

MR. WOODS: Absolutely. But I think that, and Mr. Waters has talked about access charges and he mentioned the amount of revenue that moved to AT&T. Eighty-six cents of every revenue dollar that AT&T collects from customers in the State of California we pay back to the local exchange companies in the form of access charges. So that in effect in my judgment, Pacific Bell and the other local exchange companies got the same amount or more in 1984 from what we've called intraLATA long distance than they did in 1983, and there is no question that we need to be concerned about large customers going off and building their own systems. The technology is here and when you as a large customer pay many many times what it costs Pacific Bell or the other local exchange companies to provide you with dial tone and service, the technology is there to allow you to put in your own systems, you're going to be concerned. And six-tenths of one per cent of business customers pay over half of the access charges paid by business. And although people like to throw up their hands and say bypass is something that may happen, the fact of the matter is enough studies have been done, some by Pacific Bell, we've done some, that suggests today that 11 per cent of businesses in this state who have 11 or more telephones in their business use some form of bypass as they conduct their business and they expect that to double in the next year. So access charges have to clearly move over

time toward cost and we must take advantage of those reductions and target them so we keep large users on the network

The last item I'd really like to offer for your consideration is that your support of the actions on the part of the California Commission, both in terms of access charge reduction, as well as the regulation of AT&T. Clearly, today the marketplace in California with more than 80 companies is competitive and we think that the ground rules that apply to AT&T ought to be the same that applies to others and that is not deregulation, as Mr. McEldowney said, but reregulation, an oversight form of regulation. We think it's absolutely important that the California Public Utilities Commission continue going forward into the future to oversee what's going on in the communications industry, even in the competitive marketplace of long distance.

So in closing I would just say that what we'd like to do is to continue to solicit your interest and support of the actions of the California Commission. Thank you, Senator Rosenthal.

CHAIRMAN ROSENTHAL: One final question for you, Mr. Woods. What do you think the role of the Legislature should be? You've indicated what you thought PUC should do and I can probably guarantee you there is going to be legislation in this and other areas concerning your business. What should we do?

MR. WOODS: I would offer, and I don't mean to be presumptuous, Senator, I would offer two thoughts. One, doing what you are doing now and what you obviously by your questions have done over the last year and a half, understand what's going on in the changes in this new industry. Number two, based on that understanding, I think, support the actions of the California Public Utilities Commission as they move us all with the industry's help and with yours, through this transition.

SENATOR MELLO: Mr. Chairman, may I ask, with your permission here?

CHAIRMAN ROSENTHAL: Yes, Senator Mello.

SENATOR MELLO: I've been trying to talk to somebody from AT&T for months and ...

MR. WOODS: I'm sorry I missed you, Senator.

SENATOR MELLO: ...your collection department didn't miss me. No, I'll tell you what the problem is. You see you're dealing on such a large scene that I think you're forgetting the consumers on a local level. I started getting a bill from AT&T last year and I was surprised because I'd been dealing with Pacific Bell for years. I couldn't figure out what it was and the complaint I had was you didn't even put the phone number on the bill. So I told my bookkeeper I would not pay any bill unless the number is on it because I have several rentals and I was just shocked that a large company like AT&T, that you didn't have a number along with the name. And so finally after about five months they agreed to put the number on the bill because if you don't know what phone number it is how can you reassign those costs and pass them through? To me it's given me a poor image of AT&T. If you lack that kind of what I call a very basic business, you

know, how are you doing on all this, I see you on T.V., you know the computer thing and everything else and I say, my goodness, if they bill computers like they bill consumers, I'm surely not going to be in the market for one. But I'd just like to hear from you as the first AT&T person - they did, however, turn me over to a collection agency who is arguing with me for a few bucks.

MR. WOODS: I hope not.

SENATOR MELLO: Which I'll be happy to fight them in small claims court, but it's absurd that a company like you would send me a bill without telling me what phone this is being charged to. Is that true or false?

MR. WOODS: It's true.

SENATOR MELLO: Thank you.

MR. WOODS: And I would also say from a sensitivity point of view, we were not insensitive. One of the things though is that you own or we lease that telephone to you and not against a particular telephone number. That's one of the changes that occurred. We, as Mr. Waters has suggested, have tried, and I won't say that we've been totally successful. Obviously, we have not with you and that is to try to be helpful to our customers and to move them through. But any time you get a second bill when you didn't have one before, and that bill went to 8½ x 11, which I thought was sort of a dumb idea, frankly, but that's what happened. We've got a long ways to go. We do have a long ways to go, but I certainly do assure you, Senator, we're trying to work as hard at it as we know how to try to make it as easy for you and all of our customers to do business with newly structured industry.

SENATOR MELLO: Well, the impression I have, I just don't think you're capable of taking over this giant communications structure nationwide and deal in the way that you're dealing. Hopefully, things will iron out.

MR. WOODS: Well, I think as Mr. Waters said, at least in terms of the State of California, we picked up about 15 per cent of the assets of Pacific Bell now and in terms of size, we're basically in the long distance and into terminal equipment business and we're not trying to do all things to all people.

SENATOR MELLO: Well, even what is further confusing, you have apparently certain zones in California even within an area code. Like in Santa Cruz, if I call into Monterey County, which is part of my district, AT&T bills me for a long distance call going into that different area, where it's really a puzzle. I think you would have been better off just letting Pacific Bell handle it.

MR. WOODS: I think I'll stop right at that and let you...

CHAIRMAN ROSENTHAL: All right, the next witness, Mr. Bluestein, MCI.

MR. HERMAN BLUESTEIN: Thank you very much, Senator Rosenthal and members of the committee and staff. Many of you know MCI is the nation's long distance company. In addition to the intercity voice services that we provide, MCI also provides

international voice services to a growing number of foreign countries, telex services to over 200 countries, electronic mail services to more than 100,000 customers, cellular radio in several major markets, and paging and mobile telephone services. MCI is a full service company. We operate the world's second largest telecommunications system.

Since our inception in 1969, MCI has grown into more than \$2 billion in annual projected revenues for 1985 with nearly 1.5 million customers. In fact, MCI is second only to AT&T in interexchange revenues, but it is a distant second because while divestiture eliminated AT&T's ownership of the local telephone company, it did not remove AT&T's market dominance and power in the interexchange market. When Bill Woods a moment ago told you there are 80 companies providing service, that's correct, but when you look at the market shares you would see that AT&T retains after divestiture over 90 per cent of the interexchange market. It's not the number of companies, it's the market dominance and the power they exert over the interexchange market. I think that's a very key point.

I don't need to tell you that after divestiture there's seven regional companies, but I would like to tell you that since divestiture and actually effective January 1 of this year, MCI has responded to divestiture as well as the more active role the state utility commissions are taking and the whole challenge of equal access by setting up seven divisions which correspond to the regional holding companies. So, effective the first of the year, there is an MCI telecommunications Pacific division which covers the California, Nevada, and Hawaii territory.

Although there are new players as a result of divestiture, again it has not changed the market dominance and power. With equal access implementation now in progress and continuing over the next two years, most customer choices over their long distance carrier will be made over the next two years. The challenge of equal access, and we've had a lot of discussion this morning and I really want to focus on that because that's something that we're dealing with on a day to day basis, is to make sure that the public knows what choices they have and has an opportunity to make a choice that will best meet their needs. This is a little difficult because the term "equal access" is somewhat of a misnomer. For example, and it was mentioned a little earlier this afternoon, a customer has an opportunity through informational materials that are sent to them by the local telephone company and by any direct mail materials they have received or any other information they have received through marketing campaigns by any of these companies, to make a selection. However, if that customer does not make the selection they are automatically defaulted or assigned AT&T as their carrier. So those other 79 companies really don't have quite the equal shot at those customers that some would like us to believe.

MCI and other interexchange carriers also do not have equal access to all end offices because some of these just aren't going to be converted, and further, while AT&T enjoys

exclusive high quality toll interconnection with every independent telephone company in the country, MCI and the other common carriers must continue to negotiate with the independents who are under no obligation to implement equal access. There are a number of other problems I could go into and will at any time the committee would like, that suggest that we aren't on that "level playing field". I would also say to Reed that if MCI is stolen our meager 2.5 market share...

MR. WATERS: That was a poor choice of words.

MR. BLUESTEIN: Right, I agree. But the amount of default traffic that is being automatically awarded to AT&T because the customer either doesn't know they have a choice or doesn't understand what the whole process is is a very large chunk. Senator Mello, you got a bill from AT&T and you were surprised to get it. Can you imagine the surprise of some people who had no idea that they were being assigned a carrier? This is a very significant problem. It may be as much, although we have really just started converting end offices so you really can't say from the experience at this point how many people are not selected what that default is. The limited experience we have suggests it's a fairly large number. As we're going through this process I would say, and we really haven't started with GTE yet, we haven't had any experience yet with GT upon which we can base any conclusions. We have with Pac Bell and I would say that although the first office was a little difficult and we had some problems, we have worked very closely with them. We've resolved a number of the problems and we think now that the easy access or equal access ordering process is now starting to run a lot more smoothly. What I mean by that is that a customer who does select MCI will find himself being installed at around the right time when cutover occurs and that the air rate will be very low. That's very important to us as you can imagine.

CHAIRMAN ROSENTHAL: What is that?

MR. BLUESTEIN: In other words, the failure to actually install.

CHAIRMAN ROSENTHAL: Oh, error rate.

MR. BLUESTEIN: Error rate.

CHAIRMAN ROSENTHAL: Let me ask a question now. Someone decides to go with you and for some reason are unhappy with the service. What's the problem with transferring back, either way?

MR. BLUESTEIN: No problem at all.

MR. WOODS: It costs the customer \$5.25, I believe, is it not Reed, in terms of if they want to switch from one carrier to another after they have already selected.

CHAIRMAN ROSENTHAL: I see. It doesn't require a reinstallation or...

MR. BLUESTEIN: There is no charge for the initial selection if it occurs six months of the date of the cutover of that office. If they select a carrier and choose to change, there may be that charge that Bill mentioned.

CHAIRMAN ROSENTHAL: Probably \$10.00 or something like that.

MR. WOODS: There's no physical work other than reprogramming the computer.

CHAIRMAN ROSENTHAL: I see, I didn't understand.

MR. BLUESTEIN: Although there may well be a problem if after six months after cutover and given the smaller number of people that are making a selection at this point, if they defer that decision and decide they're unhappy with AT&T or realize they can save more money using MCI and then make a change or an election later on, they may incur that \$5.25 charge for that election at a later time.

CHAIRMAN ROSENTHAL: But the only ones we're talking about are those who are going to use long distance and they've got a reduced rate so the \$5.00 really doesn't mean anything.

MR. BLUESTEIN: That's correct. And there might be promotions by any of the carriers which give them some type of credit or whatever. So that is a charge they may incur but it may be offset by some promotion.

CHAIRMAN ROSENTHAL: It really behooves you to - if you have done the job and convinced somebody they ought to leave AT&T and come to you and provide the service, otherwise you're out of business, aren't you?

MR. BLUESTEIN: That's correct. Our concern is, like I said earlier, that if a customer does not make any decisions they are automatically defaulted to AT&T so that this whole equal access process is not a process that everybody is actually being able to participate in, either through lack of information or whatever. But we think that there needs to be something done so that traffic is not automatically defaulted to AT&T and we think there is a need for a much more intensive consumer information campaign to make sure the public does understand the choices they have, the process, and has the opportunity to make an informed decision.

CHAIRMAN ROSENTHAL: Well, but that's up to you.

MR. BLUESTEIN: That's up to us and the local telephone company that has the obligation to educate their customers about the decision that must be made. On our part it's a marketing effort. On their part it's an educational effort for their customers.

CHAIRMAN ROSENTHAL: You see, I, as a user, since I was not unhappy with what it was before and for me to leave, you'd have to convince me there's some reason to leave or I'd like the automatic - to avoid more confusion. I think the fact that they stay where they are is what ought to happen. It's up to you to convince them otherwise, in my opinion. There is less confusion.

MR. BLUESTEIN: We realize that we need to have an effective and aggressive marketing campaign in conjunction with the equal process and through that we will do our very best to convince you and the public that our service is the best value for the money that they can get. The problem again, as I said, that if for some reason the person is not touched by that in any way, the selection is being made for them by somebody else which to us is offensive.

SENATOR RUSSELL: How can I as a citizen determine the number of companies that serve California, the Los Angeles area, that will be best for me or any of my constituents, for that matter? Is there a formula, a 6 step, 3 step, 24 step formula which I can use based upon my phone usage that is fairly simple to go through and compute so I can determine that you or AT&T or somebody else is better for me? Now Senator Greene says yes and I'd like to know how that works.

MR. BLUESTEIN: I have seen a number of consumer groups that have put together sort of independent evaluations and comparison of rates. I'm sure, likewise, the companies themselves will show you rate comparisons, and so forth. There really is both objective information in each company's marketing information that would assist you in doing that. I think there are a number of questions that people should be asking.

SENATOR RUSSELL: Let me stop you for a moment. Is there a basic, common floor or bit of information that everybody should understand that they can apply to their telephone bill without calling a bunch of high powered sales people in that will tell us the benefit of their own system, which is their job? I don't want to have to go through that and I would like to be able to sit down with my phone bill in some simple way, if there is such a thing, to determine whether I should one, two, or three different companies.

MR. WATERS: Senator, we'd be happy to sit down and go through the method that we suggest you do. Now whether you determine whether it's simple or not I won't be presumptuous there. But you have to look at it in terms of where you call, what the distance is and what the period of time is, but it does take a little effort.

SENATOR RUSSELL: But isn't it basically how far you call, the hour you make that call, and how often you call in certain areas?

MR. WATERS: All of those are important.

SENATOR RUSSELL: To me, if there are 24 different elements and maybe five of which comprise 70 per cent of the total cost, you'd be very well served, all of you, to say this is the way you can compute your telephone costs. Is there any kind of a thing like that without getting this tremendous pack of...

MR. WATERS: Absolutely.

SENATOR RUSSELL: ...which I throw in the wastebasket.

MR. WATERS: Absolutely. You may throw it in the wastebasket, but if it's just a little check sheet to suggest that you go through.

CHAIRMAN ROSENTHAL: Is that what you're talking about?

MR. WATERS: We have provided that to customers, will provide that to customers in terms of a little check sheet that they can use.

MR. WOODS: Let me just say one thing. There are three places you can go. You can go to the company's respective tariffs on file at the federal and state commissions that regulate them, you can go to independent materials that are put together by consumer

groups or state consumer agencies or whatever, or you can go to the marketing materials. Bill will send you some marketing materials. We'll send you some. But those are the three basic sources that somebody can go to. Obviously, the tariff one is something that nobody in their right mind would ever start to dig through to compare companies. The tariffs are an inch thick and on file in different places, but you're really left with the consumer information material people have put together and that the companies provide. There is one independent, the local telephone company is putting together materials that really is, and again I think there is some obligation on their part to help educate the public on what the criteria might be in selecting a carrier, although they certainly cannot make any recommendations or evaluate their services other than giving the public the tools necessary to make a decision.

MR. BLUESTEIN: You're right. We have an obligation, obviously, to let all the customers know what choices they have, but we can't in any way recommend AT&T, or MCI, or Sprint, or one of the other carriers. I think if we tried to analyze our customer's bill and said, based on your bill, Mr. Customer, Senator Russell, you'd be better off with one or the other of these carriers. I think we would be quickly thrown in jail by MCI, if nobody else.

MR. WOODS: Mr. Chairman, it's a lot simpler than this, I think, and that is, Senator Russell, I'll try to remember tomorrow to bring a cutout I picked up some time ago in one of the local newspapers, where simply under the conditions that you're talking about, a call of 200, 400, 600 miles, that kind of a thing, and if you were at AT&T or Sprint or Bell, a half dozen companies, what the costs would be per minute of time and so forth, which is what you're asking about. The differences would probably come through some consumer group sources because if you're going to ask anyone of these companies, they're going to tell you about them as opposed to contrasting themselves to somebody else unless they pick some narrow span in which they'd be shown to advantage compared to somebody else. So I would suggest, Mr. Chairman, I would simply like to bring it in here and make copies for you to show you what these various costs are, and having looked at those various costs I'm surprised I haven't made a change myself today.

CHAIRMAN ROSENTHAL: Well, perhaps the place to look for this information would be our Department of Consumer Affairs?

MR. WOODS: Right.

CHAIRMAN ROSENTHAL: We heard from the Director earlier. Maybe that's a service they could provide the telephone user in California if in fact they took those half a dozen points, or whatever, and gave...

MR. WOODS: Are they still here?

MR. RICHARD ELBRECHT: I'm Richard Elbrecht. I'm from the Department. I've been trying to keep abreast of the information that's being provided by this area and I've been very impressed by the volume of private consumer organizations that have been

publishing materials on this very issue. I'm sure this is something we can look at to determine whether our Department should publish anything in this area, although I do know there are quite a lot of private consumer publications dealing with the question of the selection of a long distance carrier.

SENATOR RUSSELL: Would you please run that by your boss and let a decision be made that you will or you won't?

MR. ELBRECHT: Sure, sir. We'll evaluate that.

SENATOR RUSSELL: I think it would seem to be helpful. If it's merely duplicative of what is flooding the state as a result of consumer groups, well there's a cost involved and maybe you should do it, but I certainly think that we ought to be able to provide some help to somebody.

MR. ELBRECHT: I believe the Consumer Federation of America also has a publication dealing with the issue and of course it tends to be a national phenomena because most of these firms are engaged on a national basis. But I will look into it, sir.

CHAIRMAN ROSENTHAL: Yes. One of the things that I think we need to deal with is California, and sometimes we hear figures that take into consideration the whole country in terms of whatever is happening and I happen to be elected in California and have to deal with my constituents here, so the averages that we hear don't really impress me. It seems to me that the average person out there who now has the ability to seek one of the competitive companies ought to have some easy way of determining whether they should change. They may decide not to change because they've been getting good service from where they are, so as far as I'm concerned, they ought to stay where they are. Dollars and cents is only one factor in any kind of a system and I find myself over time going to the same place because I got good service and I might be able to go someplace else and get it a little cheaper, but the service may not be as good.

MR. BLUESTEIN: Senator, I'd just like to say that I agree. We feel it should be a conscious decision as opposed to a decision being made by somebody else, an involuntary assignment to a carrier, whoever that carrier is.

CHAIRMAN ROSENTHAL: But my position personally is that everybody ought to stay where they are unless they want to change. They ought to make that conscious decision to change, and as far as I'm concerned, I'll leave them all with AT&T and if you don't convince somebody to leave, I'm sorry. That's where I'm coming from because I go back to the concept that it wasn't broke, why did you fix it kind of a thing. I'm saying that I want everybody to stay with AT&T unless they want to change. His position is that everybody ought to make a decision that's not made for them. My position is that I want less confusion out there. The ones that want to make the change will make the change.

Okay. Mr. Ringman.

MR. ROBERT A. RINGMAN: Thank you. I'm going to shorten mine very very much. It'll be a local call.

CHAIRMAN ROSENTHAL: For those who weren't here he is the Executive Vice President of the California Telephone Association.

MR. RINGMAN: It's a trade association of the 22 exchange telephone companies in California. The telephone companies in California vary in size from the very small to the very large and their service areas differ. With some the subscriber base is totally residential in remote rural areas. Others have a mix of business and residential users and serve in urban and rural areas. Only two serve major cities and population centers, as well as urban and rural areas. But from the smallest to the largest company they do provide a link in the public telecommunications network that has served Californians well these past decades.

Today you've heard from Mr. Reed Waters about divestiture and it's impact on Pacific Bell, the largest serving exchange telephone company. CTA would like to comment on the impact of divestiture on the smaller rural-serving telephone companies. Small telephone companies share most of the same concerns regarding the impact of deregulation as the larger companies, but their priorities do differ. With me today in the audience, and I'd like him to come forward, is Mr. Harry H. Baker, Jr. He is the President and General Manager of the Sierra Telephone Company. The company serves 10,000 customers in Mariposa and Madera Counties. I'd like him to comment and give his opinions in regard to the impact of divestiture on the rural-serving companies. I'll take the map over here and help Harry.

CHAIRMAN ROSENTHAL: Well, he's taking part of your time.

MR. HARRY BAKER: Chairman Rosenthal, Senators. Thank you very much for inviting the small companies to be here today. I promise you I'll be very brief.

CHAIRMAN ROSENTHAL: Thank you.

MR. BAKER: By way of introduction, my name again is Harry Baker. I'm President of Sierra Telephone. We serve in Madera and Mariposa Counties in the central part of California near Yosemite National Park. A beautiful part of the state. It's in the sixties and low seventies up there this week.

I have to characterize what has happened in the telephone industry this last year as a revolution. If we look at Webster's definition of a revolution, it's violent change and is change that is irreversible, you don't go back to the old order. I strongly suspect that there's some uncertainty about the smaller companies in California and I'd like to give you a minute or two of history.

They developed and came about for the most part around the turn of the century when there were vast areas in California and in the United States which had no telephone service. Aggressive entrepreneurs moved into that area and established telephone companies. My company was established in 1908. We had our 75th anniversary just a couple of years ago.

The structure of the 22 exchange companies in California range from Pacific Bell with

not too far from 10 million customers down to the smallest, a company in the central part of the state near Hollister with 100 telephones, that's the Pinnacles Telephone Company. It's interesting to note that the 19 smallest of the entire 22 companies in the state serve approximately one per cent of the customers. Further, the 16 smallest companies in the state serve less than one-half of one per cent of the customers in the state. And because of that disparity of size there are some differences in the way we view the industry from the way perhaps that General Telephone and Pacific Bell view the industry and the problems facing the industry.

If we look - can you see this map? These yellow areas on the map of the State of California represent that one-half of one per cent that I mentioned. My company is the largest of the tiny companies. We're at number 16 down to number one in descending order of size, and as you can see, they represent a significant amount of geography in the State of California. We're just as important in our serving area as Pacific Bell is in their's and General is in their's. General is in this blue area on the map. It's a little difficult to tell the difference between the blue and the green, but that's the general area. The green area is the area in Pacific Bell's serving territory. I would suggest that if you asked, Bob Ringman might provide you with a copy of this map. It might be tough though because it's out of print, but we're trying to get it reprinted in color.

CHAIRMAN ROSENTHAL: May I ask a question. How will you be affected then by a local measured service concept?

MR. BAKER: Local measured service is a service that we are not particularly enthralled about offering. There are those segments of the industry which think it's a panacea for a lot of the problems of the industry, and it may be, sir. I'm not sure that I'm qualified to tell you what will be true after the fact down the road a few years when it becomes more and more of a generalized service offering, but the California Public Utilities Commission presently, as I understand, is promoting the concept of local measured service and in recent proceedings before them we had to indicate to them when we would be able to offer that service. The configuration of our equipment today is not such that we can readily offer it. We indicated to them that we thought that by the end of the decade we could offer local measured service, if at that time they chose to order us to offer it. Maybe that was an answer. I'm not sure.

CHAIRMAN ROSENTHAL: I have some legislation dealing with the subject taking a look at the concept which we're waiting for results on. I'm just concerned. One of the things we've heard is that the cost of providing service in a rural area is more expensive.

MR. BAKER: I have to believe that. Yes, sir.

CHAIRMAN ROSENTHAL: And your customers have been paying a flat rate, I assume?

MR. BAKER: Yes, sir.

CHAIRMAN ROSENTHAL: I just wonder about their telephone bill if you go to the measured service. I'm certain that many of them don't just call within the area. They probably call San Francisco and other places, maybe Houston for some of their major shopping. Do you think that one of these other companies like MCI might take away that long distance business from you?

MR. BAKER: Well, understand, sir, we're an exchange telephone company. We participate in the offering of long distance service with Pacific Bell and for the moment, at least, I'm unaware of MCI or Sprint or any of the other long distance companies approaching us or any of our customers.

CHAIRMAN ROSENTHAL: That concludes your testimony, sir?

MR. BAKER: Could I have just another moment or two?

CHAIRMAN ROSENTHAL: Yes. Senator Russell.

SENATOR RUSSELL: We heard earlier about the tremendous technological advances and the expense of keeping up and so forth. Are you going to be able to maintain a parity with the giants in the industry in your smaller rural areas, in your opinion?

MR. BAKER: I can only answer that with respect to what we have done, sir, and I believe we've done a first class job of keeping up with them to this point. We don't foresee an immediate need for any fibre optics. There are several good reasons for phasing out a lot of the central office equipment that's in service today for digital central office equipment and we foresee that before the end of the decade.

SENATOR RUSSELL: Is it true that your type of business is really not so impacted by the business user as it is by more rural residential users?

MR. BAKER: Yes, sir. True to some degree, but our business customers are very very important to us. We had one business customer last year who generated \$60,000 of long distance revenue. That was unique in our history and perhaps - and he's not doing as well this year either, I'm not sure how much he's going to generate.

SENATOR RUSSELL: Do you have the same percentage of business revenues as we heard earlier that Pacific Bell indicated that they had?

MR. BAKER: I don't have those numbers on the top of my head, sir, but I think not. I'd have to agree with you that we have a considerably higher percentage of residential users.

SENATOR RUSSELL: So the pressure is not on you so much to compete as it is on Pacific Bell and General Telephone in upgrading and in being fearful of bypass and that kind of thing?

MR. BAKER: The potential for bypass is always there. I think I would have to take a middle ground among the various speakers that have been here today. I don't know that it's henny penny, the sky is falling on the one hand. On the other hand, I do think the potential is there for bypass and would have been upset had our fellow with the \$60,000 worth of long distance revenue last year bypassed everybody and gone with someone who

provided him an alternative service.

MR. WATERS: I think there's a key point, if I could add it here. Whether any of this company's customers actually bypass or not, they are sharing revenues that are generated on an intrastate basis with Pacific Bell. And to the degree that our large customers leave and do their own thing, that is less revenue that will be shared by all of the small independents, whether any of their rural business customers elect to bypass or not, and therefore it does impact the entire industry.

MR. BAKER: Absolutely true. I didn't get my minute. I'll cut it off if you want me too, but I've a couple of more brief statements I'd like to make. We've heard today about the loss of toll allocation and the concept of the subsidy. I don't use the word subsidy myself. Those toll allocations were made on the basis of conscious cost allocations by state and regulatory commissions throughout the United States. There is some potential for bypass. What I think is important to recognize is that we are the supplier of last resort in our community. The cream skimmers can come in and help themselves perhaps, but the little old lady in tennis shoes who just makes her very minimum use of the telephone, she's going to continue to look to us. We are the provider of last resort.

Another point I think should be touched on because of our limited service area, big geographically, but limited in population, we're not in the position to diversify into all sorts of knicky knack sales efforts and that sort of thing. We don't want to get into the soft ice cream business. I'd like to tell you a very brief story about one of my customers, a lady about 80 years old, Mrs. McKenzie. She came to me a couple of months ago and said, Harry, I'm confused about something. The federal court and the person of Judge Greene, the Justice Department and the FCC would not presume for a moment how to tell Frank Fat how to make noodle soup. But, in their arrogance, and I'm quoting this as close as I can, in their arrogance they saw fit to take the industry, telephone industry, turn it upside down, inside out, restructure it, and the arrogance to believe they were going to improve on it. Would you please tell me how it has been improved? I couldn't tell her. Thank you for your time.

CHAIRMAN ROSENTHAL: Thank you very much. I want to thank those who have already been part of the panel for their input. We have one panel left...

SENATOR RUSSELL: May I ask Mr. Woods one quick question? I understand that AT&T is sending to their customers, I am one of those, brochures showing prizes I can apply for if I get so many credits. I'd rather have a lower phone rate than a brochure full of things I don't need.

MR. WOODS: The interesting part about that, Senator...

MR. BLUESTEIN: Subscribe to MCI.

(laughter)

SENATOR RUSSELL: Maybe I will. Why are you doing that?

MR. WOODS: Simply because of the fact that it costs us practically nothing because the benefits that you get from other consumers, those companies are offering. And we found in this country, and others have too, that consumers like to have a bargain whether it be airplane reservations or whatever.

SENATOR RUSSELL: But does it not cost money to provide these...

MR. WOODS: It costs for the brochures but we don't pay for the prizes, don't pay for the credits, or whatever.

SENATOR RUSSELL: But by using your system I get certain credits?

MR. WOODS: Yes, that's just one of the values.

SENATOR RUSSELL: And those credits are based upon how often I use your system, how much I use your system?

MR. WOODS: Correct. Fifteen to \$300.

SENATOR RUSSELL: And so why can't I say to you, look, I don't want this. Lower your phone bill for me. Somebody else is providing me something in the brochure because I use your phone?

MR. WOODS: Sure. Absolutely. All of the vendors have signed up with us in order to provide you the discount, whether it be that you want to buy a toaster, you want to buy tires, to want to go on an airplane trip, or whatever.

SENATOR RUSSELL: It's a discount?

MR. WOODS: That's what it truly amounts to is a discount, and we think that's another value in using our service, Senator.

CHAIRMAN ROSENTHAL: And the telephone company is not paying for that, but the suppliers are selling more posters?

SENATOR RUSSELL: Okay, I get it. Another piece of that horrendous package I got from you guys.

MR. WOODS: I'm sorry about that.

CHAIRMAN ROSENTHAL: All right. Our last panel and certainly not the least in importance, the President of the PUC, Donald Vial, and the Assistant to the Chief Common Carrier Bureau of Federal Communications Commission, Carl Lawson. I assume that you have a preference as to who speaks first? I know we've kept you here a long period of time. I hope that you learned something as well as we, and that it was a good experience for you as it was for me.

MR. DONALD VIAL: It has been.

CHAIRMAN ROSENTHAL: Good. Thank you.

MR. VIAL: Mr. Chairman. Well at this time of the day, I don't think that there are very many major problems that haven't been touched upon today that pose major issues for the regulatory process in the future in dealing with the restructuring of the telephone industry. Let me point out that much has been made of the fact that in California we still have the Bell \$8.25 rate, which is the lowest in the country. Let me assure you

that that is a result of regulatory policy and in the process today you've heard the down side of all the problems we have to face now in the future in trying to maintain that kind of a rate.

Now the fact of the matter is that we are constrained at the state level in the authority that we have to deal with, the problems of a restructured industry. Action has been taken nationally and the restructure has been set in motion, not only by the Judge but also by the FCC in it's decisions that preceded the divestiture decision. I think what we all have to recognize as we deal with reality in the State of California is that the introduction of competitive forces in the move toward deregulation means that the costs of maintaining an integrated monopoly are going to be redistributed. Economists have a nice way of dealing with this in the marketplace. What they tell you is that the marketplace will allocate the resources depending upon elasticities of demand. Translated, that simply means that large users that have great elasticity of demand, more options to buy the latest technology and perhaps bypass, will have the ability to shift some of the costs of the network that they have been bearing to others who have less elastic demand. And that process has been going on and we in California in dealing with that shift in cost have been trying to mitigate the down side. And you in the Legislature have given us one handle. You gave us the Moore Lifeline Bill, which in effect said that we're going to continue to levy a kind of an excise on long distance use and use that excise tax, if you want to call it that, to maintain lifeline service.

We have done other things. We have prohibited for the time being intraLATA competition which has been pointed out to you by Pacific, that that's one-third of their so-called subsidies, to maintaining universal service. We have gone beyond that and it has been pointed out that when divestiture took place 15 per cent, I believe the figures were, 15 per cent of the assets were transferred to AT&T and 40 per cent of the revenues. Now that was given as an indication of the subsidy, but it really doesn't tell you what the subsidy is. What it tells you is that we recouped a good portion of that to the access fee that we levied on the interexchange carriers. So the real issue is how you allocate the costs and those issues are still very much unresolved in the proceedings that are going forward before us. We have indicated in our last access decision that we do not know yet how to fully allocate costs or whether costs are being allocated appropriately between long distance users and local users, and so forth.

In fact, one of the great ironies of the whole divestiture or the whole restructuring of the industry is that it's supposed to be based on cost based pricing. Cost based pricing, as you know in market economics, means that resources will be allocated to their highest use and that technological innovation will be encouraged, and that is certainly true and one of the great advantages of marketplace. Now you would think that since we launched this restructuring of the industry based on the idea of cost based pricing that we would know what the costs are at the operating level, at the local level, and that we

would know how to do marginal cost pricing in order to allocate those costs properly. Well, I'm sorry to say that we are light years behind where we are today in regulating the electrical industry. The electrical utilities, we've been ten years in developing methods of measuring and applying the revenue requirements on a marginal cost basis. We haven't approached that in the case of regulating the utilities, therefore every effort that has been made thus far to adjust and to mitigate the impact and the redistribution of the costs, the fixed costs, if you will, of the network to those who have less elasticity of demand - all of those have been done by looking at what we're dealing with at the present time in saying well, we don't have good cost figures, therefore we can't really use marginal cost figures. So we'll look at the revenue requirement and residually what we don't allocate to something else will come on the basic exchange rate.

We've gone through this looking at the embedded costs not knowing what marginal or economic costs are and we have come up with a mixture of cost based pricing, trying to get as close to cost where we have some figures and where we don't have, we do valued pricing, if you will, and in that way maintain as low a rate as possible in the basic exchange rate.

I hasten to add, however, that we may be at the end of the line on how many options we have in dealing with that. Certainly you heard a lot of testimony today about the access fee that we levy on the interexchange carrier to be distinguished from the end user access fee the FCC has promoted. That access fee, as AT&T will point out to you, is 85 per cent of their costs and the exchange carriers, interexchange carriers are saying they're too high and if we don't shift them over to the intraLATA subscribers and residually onto the end user, and you know who that is, that there will be bypass.

Now bypass is a reality. Everybody knows the great technological changes that have taken place in this industry. It is a reality we have to reckon with and surely if large users leave the system, those that remain on the system will be in worse shape than if they had not left. And bypass is the main reason for advocating a shifting of the cost to interLATA local exchange users and in the process of doing so, well, go ahead, Senator.

SENATOR RUSSELL: I didn't mean to interrupt you, go ahead and finish, if you wish.

MR. VIAL: I guess I sort of lost my thought.

SENATOR RUSSELL: Okay. Let me ask this. Is it possible for your staff to have sort of fixed in mind a generalized point at which an average company, or a larger company, would seriously begin to look at bypass? At what rate, if you apply it to the large companies, the one per cent that provide 40 per cent of their business revenues - is there any kind of a ballpark figure that you know that if the access charges get to this point they're seriously going to start looking into bypass and you better not go that far?

MR. VIAL: There have been a lot of surveys that have been made and I'm not the one

that has all of the details on those surveys, but I think it's quite clear that the access fees and what is paid for long distance for those large users who have elastic demand and have some options are going to exercise those options. That is the reality of it, Senator. Just when it will be triggered we don't have specific information on that. There have been various ways to approach it, but I've heard the Bank of America also say that even though they are potentially one of the largest bypassers, they don't consider bypass to be an imminent threat and that they're going to over the next ten years they, maybe, I don't know, if it was two per cent of their business, you might want to ask them how much they're going to use bypass. The point I want to make is that bypass is a reality, it's the basis on which we're being asked to shift costs, and in that sense it's the basis for restructuring the whole rate design or changing the rate design that exists in the industry. At the same time some people say it's a little bit of regulatory blackmail that if you don't do it all these awful things are going to happen.

Thus far we're still looking at the reality of bypass. We have established within our own PUC a committee to try to stay on top of it. Only time will tell, but the important thing that I want to leave with you right now is that we are limited at the state level in what we can do once those forces are unleashed in interstate traffic that provides for competition. And as you move toward deregulation on top of competition, you will see more and more shifting of costs in a way that will raise many equity issues, the kind of equity issues that have been raised here. Also an effort to move toward more local measured service. Now moving to more local measured service will make the local utilities healthier, but it doesn't mean that it isn't going to be part of the redistribution of the costs. It could be a slower way of redistributing those costs. In fact, we have called for demographic studies on the implementation of local measured service to see how the revenue requirement is redistributed by income groups as you move more toward local measured service.

So these are the kinds of issues that we have and the last decision that we made on Pacific we recognize now as we go into the test year '86 and the 1.36 proposal that is before us, that we had to bifurcate the proceeding because we cannot go into the rate design after we get a revenue requirement until we have more factual information. We've requested a great deal from Pacific with an advisory committee, a task force to monitor how Pacific provides that information. I should remind you that there are all kinds of users out there and you've heard from some today, but one of the problems that we have, it seems, that there are so many users that come in, large, small, manufacturing, and so forth, and they all have their own special demand on what they want, but we have the problems to resolve in the context that I've described, and the economics are for redistributing costs basically to low and moderate income families and to small business.

CHAIRMAN ROSENTHAL: Mr. Vial, do you have enough resources and staff information on this competition, which is all taking place, to make the thoughtful decisions necessary

to develop a reasoned regulatory environment in California?

MR. VIAL: Well, we don't have enough staff. The challenges are great and we could use more, but the problem is not simply additional staff. This is a rapidly expanding industry and a lot of entrepreneurs out there are trying to make their mark in this competitive world, and it's very hard to come by the people that are quality and that we need in the regulatory process.

CHAIRMAN ROSENTHAL: How can the Legislature help you?

MR. VIAL: It's quality as well as dollars for additional people.

CHAIRMAN ROSENTHAL: How can the Legislature help the PUC?

MR. VIAL: As you know, the Legislature put us on a user financing basis. We're no longer on the General Fund, and in this respect you might look at the magnitude of the problem. The dollars that we deal with in this particular industry suggest that perhaps we could use additional staff. But it's not a General Fund charge. I think it's a value judgment you have to make. We feel extremely limited in our ability to stay on top of all the developments with the present staff.

CHAIRMAN ROSENTHAL: We heard earlier, I think Ms. Siegel was complaining about what you've done on the depreciation in the telephone rate cases. Would you like to comment on that?

MR. VIAL: Yes, that's a major problem, and I think it's clear that Pacific and others are looking at vast modernization programs to be financed internally, to resort as little as possible to debt financing, and thus far it looks like they're going to be able to carry out a good portion of that modernization program without going to the debt market. I think what's important to recognize here is it is important for Pacific to modernize and to stay modern. The question really is how do you allocate the costs? What's triggering the modernization? Now the way this is done is you have to recognize that within a local exchange a lot of equipment has common use.

Now the economists talk glibly about allocating costs. They don't know how to allocate costs for these switches and other things that are in common use. No one else does either. There's no magic to it. It's a hard decision. Now when Pacific has to make a decision as to whether to put in a new switch, for example, they look at the least cost method of doing so. They look at the growth pattern of the area, they look at the existence of the present switch, they look at the labor saving aspects of the new switch, the kind of services that will be provided, going digital from analog, or whatever it may be, and this decision may be "go", this is the thing to do. And over the life of this equipment, say ten years, it's going to pay out even for present subscribers, maybe not at the beginning, but it's going to pay out because of labor savings where they make the decision now.

We don't allocate costs on a marginal cost basis, like the economists will tell you, it becomes part of the embedded costs to be allocated in the traditional way and

residually what isn't allocated to other uses falls on the local exchange. That's why residential consumer groups are highly concerned. Who is triggering the need for modernization? Is it the voice grade consumers? It could be that a switch that is in existence and has been serving 75 per cent of a group may be okay for voice grade communication for ten years, and yet something may trigger modernization and from a Pacific point of view it's "go", it's a good thing even for those present subscribers. Now if those present subscribers get allocated 75 per cent of the cost of the new switch, it may not pay out immediately.

There are all kinds of moves now for represervation, accelerated depreciation because of the competitive factors. I guess we'll have to look also at the value of that equipment as it's in place. Our staff undoubtedly will be looking at trending of the rate base as well as the accelerated depreciation requirements.

CHAIRMAN ROSENTHAL: Last November, a two day conference for the commissioners was held asking everyone in the telecommunications community to select one of four paths of regulation. Was there a consensus that came out of that?

MR. VIAL: I don't think we looked at it in terms of a consensus so much as looking at it and seeing - you mean a consensus of the parties out there? No, I think that the only consensus that you can say is what I've been trying to say, and that is the national policy to move toward competition and deregulation and unless the Legislature and the PUC and the citizens of California want to say that California is a big state and we're going to take on national policy, we're moving toward competition. The extent of deregulation is still up in the air with regard to the long line carriers. We have not made any decisions on that. As we move toward the implementation of competition and the extent to which we move more toward deregulation, there will be a greater shifting of the costs away from large users to those who have less elasticity demand, the small users.

CHAIRMAN ROSENTHAL: Thank you very much. Now, Mr. Lawson. Some people think that you're responsible for some of our problems.

MR. CARL LAWSON: Not personally.

(laughter)

MR. LAWSON: Thank you for inviting me.

CHAIRMAN ROSENTHAL: I'm pleased that you were able to make the trip and look forward to your testimony.

MR. LAWSON: Since my duties at the FCC included preparing some friends of the court briefs for the Commission in the consent proceedings, I hope I can provide some insight with respect to the FCC over the AT&T divestiture. However, I'd like to add our usual disclaimer that any views I express may not be the Commission's view.

The Commission's brief in that proceeding did say that the then proposed divestiture would be in the public interest and it would be likely to enhance competition in several markets. I still believe that this is the case. Nothing has happened in the past year

that would indicate that the long run benefits of divestiture are less likely than they appeared to be at the time.

One of the principle benefits that should flow from the divestiture is increased competition in the telecommunications equipment market. Western Electric essentially had a captive market for it's products for decades. Although FCC and court decisions that customers do not have to get telephones from the telephone company reduced that captive market, those decisions did not solve all of it. Switches and other equipment that the telephone companies use still represent a very large and very significant market. The end of the Bell System means that most of that market is no longer captive. AT&T will have to compete with other manufacturers and suppliers to provide equipment to companies such as Pacific Telephone. In theory such competition should lead to lower prices and better products and indirectly lead to lower rates for customers of those telephone companies.

Now if the telephone costs increase anyway for other reasons, it may merely mean that the rates will not go up as they would have in the absence of divestiture. If that's the case, it seems doubtful that most of your constituents will ever believe that divestiture provided any benefit to them. Nevertheless, I think they probably will realize some benefits even if they are invisible.

However, there is a down side to opening up more competition in the telecommunications equipment market. The captive market problem wasn't a uniquely American problem. In most countries the telephone service is provided by the postal ministry and although the postal ministry doesn't manufacture equipment, they usually have established relationships with one over a few suppliers. More open competition in the American market is likely to mean that the foreign suppliers will capture a greater piece of the American market. It would be sporting if the postal ministries and telephone companies in other countries responded by making their markets more open to American suppliers, however, some or most are reluctant to do that. The divestiture really has indirectly caused more attention to be focused on the problem of encouraging foreign governments and telephone companies to be more open to the American supplier. That seems to be a new hot topic in telecommunications policy today. This problem is likely to receive considerable attention in Congress and elsewhere in the near future.

We're hoping that the FCC's access charge plan will not be as hot a topic in 1985 as it has been in the past year or two. As you undoubtedly know, the Commission recently adopted the somewhat revised plan for end user or customer line charges. That plan reflected a consensus recommendation by a joint board composed of three FCC commissioners and four state utility commissioners. A \$1.00 per month per line charge, residential and single line customers, to become effective in June and will be increased to \$2.00 in June 1986. The joint board will start further proceedings in the latter part of 1986 to determine whether further changes in end user charges are warranted. The multiline

customers, of course, are already paying a charge which varies with the company but does not exceed \$6.00. That part of the plan has not changed.

Some of the major changes that have a direct effect on consumers are partly the result of another major FCC decision that occurred back in 1980. In the so-called "Computer Two" decision the FCC decided that customer premises equipment, including ordinary telephones, should be unregulated and that AT&T should offer its telephones to some entity other than its then telephone company subsidiary. The Commission was still in the process of determining when and how to implement that when Justice and AT&T entered their settlement of the anti-trust case. Justice and AT&T did decide to make the divestiture plan consistent with the FCC decision by assigning the customer equipment to AT&T. The Commission then decided the deregulation of existing equipment should take place on divestiture.

The net effect may have produced too much change in a short period of time for many consumers to absorb comfortably. The implementation of divestiture, equipment deregulation and access charges has certainly produced some very hectic times for regulators. Any transitional trauma should not, however, obscure the fact that all these actions should lead to a better telecommunications system for the country.

CHAIRMAN ROSENTHAL: I understand the basic concept that overall we may eventually end up with something better. I come from the school which says that those able to pay ought to pay and those unable to pay should pay less. Everything that's happening is moving in the direction of benefitting those who are able to pay and that bothers me a little bit because the overall benefit may be better, but on a philosophical note, the rich get richer and the poor get poorer and the ones in between fall off one way or the other. What do we do with that? Why should business pay less for long distance phone calls?

MR. LAWSON: Than they've been paying in the past?

CHAIRMAN ROSENTHAL: That's right.

MR. LAWSON: I suppose primarily because they've been paying too much in the past.

CHAIRMAN ROSENTHAL: But they could afford to pay it. They were able to pass it on.

MR. LAWSON: Well, if they passed it on then it appeared in something else, or some of it did, and from a social policy point of view it may be that the something else that it appeared in was equally essential or more so.

CHAIRMAN ROSENTHAL: But if in fact most telephone users in the country are going to pay more so that fewer can pay less, I have a problem. I understand what's happening, but what do we do with it? Why should 90 people pay more and 10 people pay less? Is that...

MR. LAWSON: I guess I would say that you can't measure the benefit strictly in terms of the telephone charges alone and add up the number of people who would pay a little more and who would pay less, but that you have to consider the sort of second level

effects which distortions have on the economy and the distortions in the prices of other things and whether in some sort of netting out of the country as a whole, it's better or worse. I guess our assumption would be with many many qualifications that the closer you get to cost based rates, the fewer distortions you're going to have and the more incentives, both for the telephone companies and their customers, to do things in the most efficient way.

MR. VIAL: May I comment on this? I think you're asking a crucial question and the answer that the economists will tell you in the regulatory sense is that we have no choice because if you don't reduce the costs to the large users, they have the technology to bypass and therefore they'll do so regardless, unless you prohibit it. I think that when you ask the question, is it going to be healthy or not, you have to look at it in terms of what we had in the integrated monopoly. In the integrated monopoly we had a lot of research going on through the Bell Laboratories in doing tremendous things in providing the underpinning and a lot of research for Silicon Valley. It isn't that there wasn't a lot of innovation under that monopoly system, it was a lot of basic research but slow on the application side, on the applied side. If you move toward competition and you say that large users are paying above costs and you want to move toward cost-based pricing, you're saying you want to allocate more resources to the applied side, the introduction of all of the kinds of equipment that you see that goes along with the decision made by the FCC to deregulate.

Now you could deregulate CP, the consumer premises equipment, without restructuring the industry, but, we've gotten into the restructuring of the industry and by doing so we've now put the priority on the applied side, and this explains that you'll see a lot of gadgetry along with a lot of real innovation. You may see for awhile, as you have competition with regulation of the predominant carrier and non-regulation of the new entrants, you may see a lot of investment and overinvestment in order to get into the game. How that will shake out over time and who will bear the costs of the overinvestment, all of these are economic issues that have to be confronted, but basically if you say what is good or what is bad it depends on how you look at a telecommunications system and the type of service it is. If you look at it as a service that's going to increasingly be like any other service you buy and sell in the open marketplace, then the way to go is competition and deregulation with a lot of products out there looking like a smorgasborg. If you're going to approach that then you have to say, well, you have to have money in your pocket to buy at that smorgasborg so you have problems for large business, small business, and residential users. There is no clear answer to the question.

CHAIRMAN ROSENTHAL: Why isn't the emphasis, on the other hand, instead of me as a home user paying \$1.00 a month more for access, why don't we let those who bypass pay the excess?

MR. VIAL: That's a matter of policy and if we tried to do it at the state level in the context of national policy we're first told that the FCC may step in and assume our jurisdiction because we may be interfering with interstate commerce and the decisions related to that. So there is always great reluctance by the lawyers to step out too far and take on national policy. For example, should we take on national policy with regard to the represcription of depreciation? The FCC has already indicated and moved in the direction of taking over state jurisdiction. We're in court on that. There are many areas where if we try to draw the line on national policy we may lose our jurisdiction. And that's the problem we need to discuss further in the State of California - where do we draw the line? At what point do we say enough is enough and we've got problems we've got to take care of? We can't do it alone at the PUC.

CHAIRMAN ROSENTHAL: Senator Greene.

SENATOR LEROY GREENE: Thank you, Mr. Chairman. Listening to the discussion here and talking about who is paying how much to what relating to big users and what portions of total costs they pay and why should this side of the equation go down when this side goes up, but doesn't the gross cost for telephone users, be they the smallest individual or the little old lady in tennis shoes to the biggest corporation around, does not the gross cost for all users combined go up every year compared to the previous year?

MR. VIAL: I may need some help on that. Duncan Weise, is our Chief of the Policy and Planning Division. My impression is that the technological breakthroughs have made possible for costs to come down in many respects, certainly in long lines use. I think it's been made clear here that much of the technological advancement there has been used to support the local exchange. Now we don't know that we have resolved the allocation issue on how cash really should be allocated, but that's what is asserted.

SENATOR GREENE: But if he took some gross figures, if he took the total amount of the bill in the United States of America for long distance, okay? I'm going to take the total bill and divide it by the number of calls made throughout the whole country, no matter where they went to. True, there's all kinds of variations, this is gross. Maybe gross in a gross fashion, but wouldn't we find nonetheless that over time the cost of that unit, you took the whole thing and divide it by the number of calls, is going up not down? What you would simply find is that the number of calls increased, okay? But still...

MR. VIAL: The productivity of the system is increasing, but you're getting all kinds of enhanced services and changes in quality of services and it's difficult to separate out those changes from the unit price.

SENATOR GREENE: At the same time, though, one would think that as the volume increased the unit cost should go down, but it doesn't seem to. Perhaps because of the enhancements that you're talking about of other kinds of things you can do, whatever they are, of the whole computerization area. But it seems to me that over time that telephone

use is such that an increase in volume does not go along with the decrease in unit costs. An increase in volume seems to be accompanied by an increase in costs. Is that reasonably stated or unreasonably stated?

MR. VIAL: I say, maybe you can answer this, but my feeling is that there have been technological innovations which reduce unit costs from what existed so that we've had expansion in long lines and the cost savings there have been in part used in what we call the subscriber plant factor method of allocation to support the local exchange. Now how that breaks out in terms of long run unit cost per certain types of things, I can't answer that but I'm sure that our staff could come up with some figures and I can supply them to you.

SENATOR GREENE: Well, I guess what you've told me in a sense is, yeah, wow, we're selling ten times as many automobiles from all manufacturers than we did "xteen" years ago, and it's true that everyone of those cars cost many times what they did many years ago, but there's all kinds of extra things about these cars that they can do, so that's why the unit price of the car doesn't come down, it goes up.

MR. VIAL: I'm not so sure that the automobile industry is a good example of where we're going with...

SENATOR GREENE: Can you help, perhaps, with an equally bad one then?

MR. VIAL: I think you're making a very good point. We talk about competition and possibly deregulation. Now we have not decided in California how to regulate the interexchange carriers. Right now we regulate AT&T as the dominant carrier but the others have ease of entry and virtually just tariff filing for how they compete. Now we don't know how this new competition is going to shake down, it could become an oligopoly as in the case of the automobile industry where we saw for years how the automobile industry applied oligopoly to the larger cars selling them by the ton while we lost to the foreign markets. So you can't really tell how this is going to play out in the long run.

SENATOR GREENE: I'd venture to say that you probably could make a comparison of what the gross costs were for telephone services the final year prior to divestiture and perhaps not the first year thereafterwards, there's all kinds of confusion, but maybe a second or third year after - that if you related the gross costs to the gross amount of services rendered and question which way we're going - uphill or down?

CHAIRMAN ROSENTHAL: Mr. Waters, Reed?

MR. WATERS: Clearly our unit costs for switching equipment, the thing that makes connections for customers over the network, are going down dramatically. That's one reason we want to modernize because it costs us not only less to accommodate a given body of 10,000 customers, but far less maintenance, far greater reliability.

SENATOR GREENE: But how does that in any way relate to my bill going down? My bill doesn't go down when you do those things?

MR. WATERS: That's only a part of our plan. It costs us just as much and more each year as wages go up and as the costs of our raw materials go up to build the copper mine, I'll call it a coppermine, but it's the wires, poles, and all of that hard plant that sits out there to serve individual customers. As we move into a fiber kind of world, and we're gradually getting there in our metropolitan areas, it will be a long time before we get a fiber to every residence. On the other hand, that is going to also, I think, see a downturn in costs. If you look at the total expenses of Pacific Bell as it relates to the expense for each telephone, that trend line is coming down over the years, but you forget that Pacific Bell has to serve something like 400,000 new telephones that didn't exist last year, each and every year as we move downstream. So we need to grow the plant to the degree of building new plant and each of those new services that we have to provide for, each of the 400,000, costs in the area of capital investment, right up front, around \$2,000. And you figure that out and that's where you come out.

SENATOR GREENE: What costs \$2,000?

MR. WATERS: Costs around \$2,000, roughly \$1,600 per customer for the central office alone, and we're collecting \$8.25 or for a lifeline customer who uses just the same amount of plant, it doesn't make any difference...

SENATOR GREENE: But wait a minute. You're telling me it costs you \$1,600 per customer...

MR. WATERS: Yes, per access line.

SENATOR GREENE: ...and then you give me something about \$8.25 which is per month.

MR. WATERS: That's all we're charging for that investment that costs us \$2,000.

SENATOR GREENE: Well, I appreciate your losing money so willingly, but something keeps you in business. What is it?

MR. WATERS: Long distance and access charges to carriers.

SENATOR GREENE: I see, and if you didn't have long distance then you'd go out of business because you couldn't make it on your local calls, is that what it is?

MR. WATERS: Couldn't make it on the local service because it literally supports the investment that we have, and the average investment we have right now is about \$1,600 for all of the plant we have in service, \$1,600 per customer, average, for 8.5 million access lines and we're collecting \$8.00 on the average for that, more for business, and we're collecting - and it costs us \$29.50.

SENATOR GREENE: I presume that what you're telling me is accurate information so why is it I have so much trouble believing it?

MR. WATERS: With doing what, Senator?

SENATOR GREENE: Accepting it? I can't handle those big figures and the little figures. Somehow or another it doesn't compute.

MR. WATERS: They're facts.

SENATOR GREENE: Okay. Somehow or another I had trouble then with that set of facts.

I find it difficult to believe...

MR. WATERS: Senator, let's take it from this basis. We have 8.5 million customers. We have \$18 billion in investment. Divide the numbers and what do you come out?

SENATOR GREENE: Yes, but when you made those investments there were given periods of time over a long period, I don't know how far which dollar went compared to what other dollar, okay? I can't make the...

MR. WATERS: The dollars are always escalating as you go forward.

SENATOR GREENE: Yes, and that's what makes it too difficult for my simple mind to take those simple pretty little numbers and say if you divide this by that you come out with that and therefore it's \$8.00 a month and I'm losing his shirt. It's like the grocer tells me his markup is only one per cent or a half per cent, but he forgot to tell me it's per day because he's doing this every day.

MR. WATERS: I don't want to mislead you. The \$8.00 a month covers the, is all we're collecting really on the non-traffic sensitive portion of that customer's service, plus a portion of his local free usage that he doesn't pay for on a unit per unit basis.

SENATOR GREENE: Yes, and there's also a great number of customers out there who are paying you that basic price and weren't home that month and didn't use the phone at all, and even when they were home they didn't use any basic amount.

MR. WATERS: Absolutely. That's correct and I'm suggesting that my costs are still there because we spent the investment to buy the wires...

SENATOR GREENE: But that little old switch is not switching so it's going to last a little longer, okay?

MR. WATERS: Say that again, Senator.

SENATOR GREENE: Well, this little switching device in here because everytime I point down these numbers I'm going through all this rigamarole to get my call through, but I'm not making the calls so therefore I'm not using up your equipment so fast either.

MR. WATERS: We still have the wire and we still have to earn on that investment that we've made to build the wire and hang it out there and stretch it for 20 miles...

SENATOR GREENE: Yes, but what happens after you've gotten ten times what that wire's worth? So here I ask you for a little cord here on my phone, okay? Instead of a four-footer you're going to give me a nine-footer or an eleven or whatever the darn thing is...

MR. WATERS: We're not going to give it to you at all anymore, Senator.

SENATOR GREENE: ...instead of giving me that other buck's worth of cord you're going to tell me that I have to pay you rent on it from now till Hell freezes over, and then talk to me about all these things. Hey, there's that which computes and that which doesn't. My binary system works different. Thank you, Mr. Chairman.

CHAIRMAN ROSENTHAL: Any further questions. Would either gentlemen like to say anything further?

MR. VIAL: I'd just like to thank you for having us here. It was a very worthwhile session. It's good to hear the parties come before you and set forth all the problems that are facing the California Public Utilities Commission. We look forward to working with the Legislature and keeping as informed as best possible and what our options are.

CHAIRMAN ROSENTHAL: We're going to try to solve your problems. Thank you very much for attending. It went longer than I thought it was going to, but I found it very informative, very educational and I hope the other members did as well.

--oo0oo--